No. 15,096

IN THE

# United States Court of Appeals

## For the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE,
*Petitioner,*

vs.

THE STONECREST CORPORATION and
THE BROOKFIELD CORPORATION,
*Respondents.*

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On Appeal from the Decisions of the Tax Court of the United States.

## BRIEF FOR THE RESPONDENTS.

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## BRIEF FOR THE RESPONDENTS.

### JURISDICTION.

The taxes involved herein are the Federal income, declared value excess profits and excess profits taxes for the years 1942, 1943, 1944 and 1945. Notice of deficiency was mailed by the Commissioner to The Stonecrest Corporation on April 9, 1952, relating to the above taxes, for the years specified (R. 7, 17); and on the same date, notice of deficiency was mailed to The Brookfield Corporation (R. 68, 87). On July 3, 1952, petitions were filed in the Tax Court by each of the respondents separately (R. 1, 4), for a redetermination of the aforesaid deficien-

cies (R. 6), and an amended petition was filed by respondent The Brookfield Corporation Nov. 4, 1954 (R. 5, 68). Motion to consolidate the two cases for hearing and decision by the Tax Court was granted September 21, 1953 (R. 2, 4, 121). The Tax Court entered its decision, in each case, on October 13, 1955 (R. 139-142). On January 12, 1956, the Commissioner, petitioner herein, filed separate petitions for review of said decisions (R. 142-146), pursuant to the provisions of Section 7482 of the Internal Revenue Code of 1954. On April 19, 1956, the parties stipulated that the above two cases be consolidated before this Court for review and decision (R. 150).

The amount of taxes alleged by petitioner to be *involved* in this appeal, totals, for the two corporations combined, $767,502.05, plus interest. It is to be noted that petitioner does not claim that this is the amount of taxes *due* from respondents. The schedules (Pet. Br. p. 2) of amounts involved on appeal, merely show the amounts specified in the Commissioner's Notices of Deficiency, both dated April 9, 1952 (R. 7, 69, 120-121) with certain exceptions and modifications.[1]

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## QUESTION PRESENTED.

1. As stated by petitioner himself, in his petitions for review (R. 143-4, 146), "The case presents for adjudication the question whether under terms of agreements of sale the buyers from the taxpayer of real property that had a mortgage on it did not assume the mortgage or

[1]See Appendix B for details of such exceptions and modifications.

take the property subject to the mortgage within the meaning of Treasury Regulations 111 Sec. 29.44-2, relating to the determination of the percentage of taxable income to be returned on the installment basis as permitted by Sec. 44(b), Internal Revenue Code of 1939."

2. The case, further, presents for adjudication the question whether the aforesaid Regulation, if interpreted as contended for by the Commissioner, is invalid, because of conflict with the basic statute, Sec. 44.

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## STATEMENT OF THE CASE.

Almost all the facts in this case have been stipulated by the parties (R. 19-48 for The Stonecrest Corporation, and R. 48-67, 117-119, for The Brookfield Corporation) and the Tax Court below, in its findings of fact, found them accordingly and incorporated them by reference (R. 121). Except where otherwise specifically stated, the facts set forth in the Stonecrest stipulation apply likewise to the Brookfield Corporation (R. 54).

Respondent Stonecrest Corporation is a California corporation organized January 5, 1942 (R. 19). Respondent Brookfield Corporation is a California corporation organized February 27, 1942 (R. 49). Each of the respondent corporations was formed for the purpose of helping to meet the acute shortage of low cost housing, for war workers in the defense effort, following Pearl Harbor, and at the instigation and urging of representatives of the War Production Board. Under the uncertain war conditions then obtaining, this was considered a precarious undertaking (R. 90-92, 95-96). In pursuance of these

purposes, respondents, as their principal business during the tax years in question, engaged in the acquisition of land, planning and subdividing of land, and making necessary improvements, and constructing and selling individual residences on the improved lots (R. 20, 49). Insofar as here relevant, respondents kept their books and reported their profits on the installment basis (R. 122).

During the years 1942-1945, inclusive, Stonecrest developed three subdivisions in the San Francisco area, and Brookfield developed a single subdivision in Alameda County (R. 21, 49). Respondents' method of operation was as follows:

In the case of Stonecrest, the corporation first purchased unimproved land from a pre-existing partnership, Stoneson Bros., whose members were also shareholders of respondent. Stoneson Bros. had purchased the tract, prior to the organization of respondent, the purchase price being financed partially by partnership funds but principally by a loan from the San Francisco Bank. The said loan was evidenced by a promissory note executed by the partners and their wives and secured by a blanket deed of trust covering the entire tract in favor of the lending bank (R. 122, 22).

Stonecrest, having purchased said unimproved land from the partnership, then submitted its plans for building individual residences to the Federal Housing Administration, and after obtaining the general approval of the F.H.A., respondent applied to the San Francisco Bank for specific construction loans for the construction of individual housing units, which were made after an F.H.A. commitment to insure each separate loan had been se-

cured (R. 122, 23). Each such "construction loan" was secured by a deed of trust note and a deed of trust on each unit, which was recorded by the Bank.

The original blanket deed of trust on the entire tract was released on such individual lots as loans for the construction of housing units on these lots were made, an agreed release price being paid to the mortgagee Bank out of the construction loan (R. 122, 23-24).

When all the lots in a subdivision developed by respondent were subject to such individual deeds of trust, the stockholders of Stonecrest and their wives, who had personally signed the original note and blanket deed of trust, were released from their personal liability thereon, so that at all times *only respondent Stonecrest was liable to the mortgagee Bank on the deed of trust notes with respect to houses covered by installment contracts that had not been closed* (R. 122-123, 30).

In the case of respondent Brookfield, procedure relating to the acquisition of land and financing of construction was identical with the above circumstances relating to Stonecrest, with the exception that Brookfield acquired its tract of unimproved land from a partnership consisting of Henry Stoneson, Ellis L. Stoneson and Albert Bernhardt, and that, when securing construction loans from the San Francisco Bank for individual houses, the said persons, and their respective wives, being all of the stockholders of Brookfield, were required personally to guarantee each individual note secured by individual deeds of trust on the houses constructed and sold, and they were never relieved from their secondary liability on such loans until the loans were either paid in full,

or, as in a few cases not here in issue, assumed by the purchaser (R. 123, 55).

In each case, such construction loans, secured by deeds of trust upon individual lots (which encumbrances are the mortgages the effect of which is at issue in the present case), were thus completely obtained by respondents from the mortgagee Bank *before the appearance in the transaction of the purchaser of the individual house,* in any manner. Only after securing such loans, and giving such mortgages, did respondents proceed to construct and sell the individual houses (R. 23-24).

With the exception of a very few cash sales, not here at issue, all of these sales were installment sales (R. 20, 31). When a sale was agreed upon, purchaser signed various preliminary documents, including a Deposit Receipt and an F.H.A. certificate of employment, and when the house was ready for occupancy, a ''Uniform Agreement of Sale'' was executed by purchaser and respondent (R. 123, 24-25).

This agreement called for a small down payment of approximately $100 or $150 upon a purchase price of approximately $4,500, and provided that the balance should be paid in monthly installments over a period of 20-25 years (R. 20; Exhs. 7(a), 7(a-1), 7(a-2), 7(a-3), attached to Stonecrest stipulation; R. 51). The total purchase price, payable in such installments, was in no way diminished by reason of the mortgage on the property. The contract referred to the existing deed of trust covering the property, as security for a note of approximately $4,000, and obligated the vendor to pay off and meet the requirements thereof, as they came due monthly;

and the amount of the installments was calculated with reference thereto. Right to possession was immediate, but the purchaser did not receive present title. Upon payment by the purchaser to the respondent of the full sum designated in the contract as the purchase price, he was entitled to receive a deed free and clear of the mortgage (R. 124-5, 47, 67).

The level of payments which the purchaser was required to make in his installments, during the first 27 months, was somewhat greater than the level of payments during the remaining period of the installment contract, the difference in level representing the excess of purchase price (less down payment) over the original amount of the mortgage loan (plus interest on such excess) (R. 127, 46, 60).

Under the contract, the purchaser did not assume the mortgages, *or become in any way liable to the mortgagee Bank with respect thereto* (R. 30, 55-56, 136). On the contrary, the contract provided for a *possible future* assumption only, after a period of years, *upon a contingency that never in fact, occurred.* Thus it was provided, in one form of the contract, that *after a period of approximately two to seven years,* the seller should deliver, and the buyer accept, conveyance of the property, "*at option of Seller,*" and purchaser "shall *thereupon* assume the performance of Seller's unperformed obligations" under the mortgage, "and Purchaser hereby consents to Seller being *then* released therefrom" (R. 125-6). In other forms of the contract, the provision was the same, except that the option was given to the buyer (and the period of its potential exercise 8 to 12 years distant). But none

of these provisions ever came into play, for in no single case did respondents, or a purchaser, exercise such option to receive a deed prior to full payment of the purchase price (R. 127, 25-26).[2]

In connection with such potential future assumption, the Uniform Agreement of Sale recited that "*for this purpose,* Purchaser executes an assumption concurrently herewith, delivers same to Seller, and the Seller is authorized to deliver said assumption to the San Francisco Bank upon delivery of said conveyance" (R. 125-6). In the actual carrying out of the agreement, however, the document actually signed by the purchaser, to be used if and when the option was exercised and the property conveyed, was not an assumption, but the purchaser's guarantee to the Bank of respondent's mortgage loan; so that even if title had passed before complete performance by the purchaser, the respondent would have remained primarily liable to the mortgagee Bank for the full unpaid balance of the mortgage (R. 127, 30-31, Exh. 7(b) attached to Stonecrest Stipulation).

Among the documents executed by a purchaser from respondents was a "Mortgagor's Statement" contained

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[2]In a few cases, by special arrangement, purchasers were permitted, as a matter of privilege and for personal reasons, and not as a matter of right on the part of either party, to assume the mortgage, and given a deed to the property, without payment of the full purchase price. In each such case, purchaser arranged with the Bank to assume the mortgage, and paid respondent the excess of the balance then due on the installment contract over the balance due on the deed of trust note; and in each such case, the installment contract was closed on respondents' books, and the entire balance of profit to be realized reported as current income. None of these few cases involved the exercise of any option given to either party under the agreements of sale (R. 129, 29, 53-4).

in a "Mortgagee's Application for Mortgage Insurance," which was filed by the lending Bank with the F.H.A., together with a "Purchaser's Certificate," contained in a "Consent to Substitution of Mortgagor under Title VI" (R. 123; Exhs. 6(c) and 6(d), attached to Stonecrest Stipulation). These two documents, as appears from the above (*supra,* p. 6), were executed *after* the completion of the loans from the mortgagee Bank to respondent, and the giving by respondent of the mortgages herein involved. They thus related, necessarily, not to the granting of the loan, or to the status of the present mortgagor thereunder (viz., the respondent), but only to the possible future assumption of the mortgage by the purchaser, and his possible future substitution as mortgagor, in place of respondent, as provided for in the Uniform Agreement of Sale, *supra,* p. 7. This appears affirmatively from the face of the documents themselves. Thus, the "Consent to Substitution of Mortgagors under Title VI," Paragraph "A" (entitled "Mortgagee's Request for Substitution") recites: "We are informed that *title* to the property covered by the above numbered loan has been *or will be* transferred from the Stonecrest Corporation," etc., "and your consent is hereby requested to the release of the seller (Stonecrest) from liability under the above numbered loan *upon the assumption of such liability by the purchaser* and *upon proof that the purchaser has paid on the purchase price at least 10% of the F.H.A. valuation* (as of the date the mortgage *was accepted* for insurance) in cash or its equivalent."

Further, in the same document, Paragraph "B" ("Preliminary Approval") the Federal Housing Administra-

tion declares that it will give consent to the requested release "subject to the following conditions: (1) the proper execution of Paragraph (C) or (D) on the reverse side hereof . . ." and said Paragraph "C," entitled "Purchaser's Certificate," recites that "the undersigned (purchaser) hereby certifies *that title to the property* identified in Paragraph (A) hereof *has been conveyed to him* and *that he has paid on account of the purchase price* ...... dollars [i.e., the necessary 10% of F.H.A. valuation] in cash; that he has assumed and agreed to pay the obligation identified by the above loan number . . . and that the undersigned is the owner . . . of the subject property." Obviously, these recitals speak as of a possible future date and state of affairs only—a state of affairs which never materialized. They were applicable in case of exercise of the option to take title and assume, set forth above (*supra,* p. 7). They were not true, at the time of the sale; title had not passed—and never did pass until full payment of the purchase price; nor had the purchaser paid the requisite 10% of the F.H.A. valuation, on the purchase price.

Neither the Bank nor the F.H.A. retained an executed copy of the above "Purchaser's Certificate," or of the purchaser's guarantee to the Bank of the loan made to respondent (R. 25, 124).

At the time of execution of the Agreement of Sale, purchaser, in accordance with its terms, also executed a quitclaim deed to the property in favor of respondent. This, likewise, was intended only for use in connection with a possible future contingency, viz., default by the purchaser (R. 126, 25). The purchasers were war work-

ers, largely migratory, whose financial responsibility was very uncertain (R. 91, 95-96, 109).

In each installment sale herein involved, with the exception of sales by respondent Stonecrest in the year 1945, the amount of the mortgage on each house sold was in excess of the cost of such house to respondents (R. 45, 66-67).

The language of the formal written document, the Uniform Agreement of Sale, provided that installment payments or parts thereof, should be applied by the Seller to payments on the mortgage loan (R. 125). But the actual carrying out of the contracts uniformly excluded anything in the nature of earmarking of any specific payments by the purchaser, or any intended synchronization of payments of installments by the purchasers to respondents, with payments by the respondents to the mortgagee Bank on the mortgage loans (R. 128). The liability of the purchasers to make payments to respondents under the installment contracts, and the liability of respondents upon their individual loans from the mortgagee Bank, were at all times kept strictly separate.

Thus all monthly payments on installment contracts were made directly to the respondents by the purchasers, and such purchasers, except at the commencement and expiration of their contracts, were not informed of payments made or amounts due on respondents' loans (R. 127-128, 29-30). All payments due on such loans were made directly by respondents to the mortgagee Bank, which carried all such loans on its books as loans due from the respondents (R. 127-128, 27). It is stipulated that purchasers at no time during the life of the con-

tracts had any liability to the Bank with respect to respondents' loans; and that, at all times, respondents alone (or in the case of Brookfield, respondent and its stockholders and their wives) had sole liability on the loans (R. 30-31, 136; *supra,* p. 5); from which the Bank would not release them prior to full payment (R. 31).

All funds received on installment contracts were deposited in the respondents' general bank accounts, and no part of such payments was ever put into any special account, or segregated or earmarked in any way (R. 38-39). Payments by respondents to the Bank upon their loans were made out of respondents' general funds (*id.*).

Payments made by the purchasers on the installment contracts did not, in actual practice, coincide with payments made by respondents on loans due by them to the Bank. Due to differences in the date of commencement of the obligation to pay, and in the duration of the contracts as against the duration of the loans, the balances due, in the great majority of cases, could never coincide (R. 32-37). There were, moreover, frequent delinquencies in payments due on the installment contracts, often totalling hundreds per month (R. 37-38); whereas payments by respondents to the Bank upon their loans were in all cases paid promptly and in full, without reference to the state of payment upon said installment contracts (R. 37, 27). The amounts paid by respondents to the Bank were in accordance with monthly statements summarizing amounts due on all outstanding loans, and each respondent paid the aggregate total due by it to the Bank, on all loans, in a single check (R. 27).

In their tax returns for the years here involved, respondents elected to report the sales as installment sales, under I.R.C., Sec. 44,[3] and, in accordance with said section, reported as income "that proportion of the *installment payments actually received* in that year which the gross profit . . . to be realized" when payment was completed, bore to the total contract price. Respondents considered the "total contract price" referred to in Sec. 44 to be the amount for which a property was sold, without any deduction for the amount of the mortgage, or any part thereof (R. 129, 47, 52).

The Commissioner, in determining the amounts considered properly reportable as income, upon the installment basis elected by taxpayers, purported to rely upon the provisions of Reg. 111, sec. 29.44-2, and proceeded as follows: (a) he held that the "total contract price" was not the purchase price designated in the contract, but should be arrived at by deducting from such purchase price, the amount of the mortgage, to the extent that it did not exceed the vendor's basis (R. 129, 42-3; Petitioner's brief herein, p. 15).[4] (b) Dividing the total profit to be realized on the sale by the figure for "total contract price" arrived at in the above manner, he reached a figure of 100%[5] as the percentage to be applied in accordance

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[3]All references herein to I.R.C. are to the I.R.C. of 1939 in force prior to 1954 amendments.

[4]The statement by the Tax Court below (R. 129) and repeated in Petitioner's brief herein, p. 14, that the Commissioner added the excess of the mortgage over the seller's basis, to the basis, to determine "total contract price," was an obvious inadvertence. See R. 42-43; 132; and Petitioner's brief herein, pp. 15, 18.

[5]For the year 1945 (when the amount of the mortgage did not equal vendor Stonecrest's basis) the Commissioner reached a figure of 83.5% (R. 42).

with the statute, sec. 44 (R. 43, Pet. br. herein p. 15). (c) Commissioner, likewise purporting to be acting in pursuance of the above Regulation, defined "initial payments" as including, in the year of sale, the excess of the mortgage over the respondent seller's basis (R. 130). (d) Commissioner then applied the 100% figure, *not* to the "installment payments actually received in that year," prescribed by sec. 44, but to the down payment at the time of sale, *plus* the said excess of mortgage over respondent's base; and, also, to *a certain part only,* of further installments actually received during the year. The item comprising those parts of installments actually received which Commissioner recognized, was designated "Other collections on contract price" (R. 43; Pet. br., p. 16), and this item included only the amount by which installment payments made during the first 27 installments (less interest therein) exceeded the level of payments prevailing during the remaining term of the contract (R. 46-47, 63-64). All the remainder of the installment payments actually received (necessarily including all of the installments after the first 27 months) were ignored, at all times (R. 47). Here, too, the Commissioner purported to be acting in pursuance of the above Regulation, although this contains no authorization for ignoring any installment, or any part of any installment, actually received.[6]

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[6]For the respondent Stonecrest, the Commissioner excluded from consideration the following amounts actually received by Stonecrest from purchasers in the installments: in 1942, \$12,-243.34; in 1943, \$267,658.86; in 1944, \$247,624.56; and in 1945, \$261,190.86.

For respondent Brookfield, the corresponding figures were: in 1942, \$56.92; in 1943, \$74,411.89; in 1944, \$112,608.70; and in

In the Tax Court below, respondents contended that the Regulation relied upon by petitioner was not applicable to the facts of the present case, which came neither within the express terms thereof, reasonably construed, nor within its intent and rationale; and further, that if such Regulation were construed as contended for by petitioner, so as to be here applicable, it would be invalid because of conflict with sec. 44 (R. 116; Pet. br. herein, p. 30). The Tax Court, in its opinion, found no necessity to consider whether the Regulation would be invalid, if construed as contended for by the Commissioner, but held that such construction was not tenable, and that the Regulation had no application to the kind of transaction involved in the present case.

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## SUMMARY OF ARGUMENT.

1. Sec. 44, I.R.C., conferred on sellers of property on an installment basis, the privilege of deferring the report of what, under ordinary and generally applicable principles, was present income, until future years, when installments were actually received. It permitted vendor to distribute the total profit on the sale, for tax purposes, over the entire life of the sales contract; and applied a uniform percentage, the proportion of gross profit to total contract price—i.e., the overall rate of profit on the en-

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1945, $241,262.02. (These latter figures include minor amounts relating to certain sales, not reported on the installment basis, not here at issue.)

(The above figures are arrived at by calculation of the differences between the amounts stipulated as "installment payments actually received in cash" and the amounts recognized by Commissioner (R. 39-43, 60-65).)

tire sale—to each installment, when actually received, to determine reportable income of the year in question.

Where the property sold on the installment basis was mortgaged property, great administrative difficulties arose in the application of sec. 44. All of these difficulties arose, however, from a single factor, viz., that under the common forms of transfer of mortgaged property, the full selling price of the property is not paid into the hands of the vendor; and the "installments actually received" by him constitute a *part* only, of such full selling price. The entire amount of the mortgage is customarily absent from the installments actually paid to the vendor. As the Supreme Court pointed out in *Burnet v. S. & L. Bldg. Corp.,* 288 U.S. 406, under these "unusual circumstances," application of the statutory percentage (which is the overall rate of profit on the entire sale) to the installments actually received by the vendor (which are only part of the full selling price), could not reach the entire profit on the sale. In order to do so, it would be necessary for the Commissioner to base a further tax upon dealings between third parties, the purchaser and the mortgagee—a procedure which, as the Supreme Court pointed out, "would inevitably lead to many practical difficulties," might unduly postpone or lead to escape from collection of taxes, and could not be determined from the vendor's own books and records.

To deal with these administrative difficulties, the Regulation here involved was promulgated, and, *upon the ground of these practical necessities,* sustained by the Supreme Court in the *S. & L.* case, *supra.* Said Regulation applies by its terms to mortgaged property "whether

the property is *merely* taken *subject* to the mortgage or whether the mortgage is *assumed* by the purchaser.'' In both these common forms of transfer, in the usual meaning of the terms employed, the amount of the mortgage is not paid to the vendor, and is not part of the ''installments actually received'' by him; so that all of the practical difficulties adverted to by the Supreme Court in the *S. & L.* case, *supra,* are present, and the Regulation, which was designed to meet those difficulties, is applicable.

In the present case, however, the purchaser has *neither* ''assumed'' the mortgage, nor was the property ''merely taken subject to'' the mortgage, in the usual sense of that term, which implies abatement of the purchase price payable directly to the vendor, by the amount of the mortgage. The sales in the present case belong to what is well recognized by the authorities as a *third* category (see *infra,* pp. 25-28) where the purchaser pays the vendor the full price for the property, undiminished by the mortgage, and the vendor in turn engages to pay off the mortgage and give purchaser a clear title.

The distinction between this *third* category and the two types of transfer of mortgaged property dealt with in the Regulation, is not a mere technicality (which is the main burden of the argument in the Commissioner's brief herein), but, on the contrary, goes to the essence of those problems in the application of section 44, which, as the Supreme Court held, are the very reason and justification for the Regulation. The transfers, in this third category, are wholly outside the rationale of that Regulation. For here, the ''installments actually received'' by the re-

spondent vendors *include the entire selling price of the property, undiminished by the mortgage.* Consequently, none of the above practical and administrative difficulties, arising in the two other types of transfer, which necessitated the Regulation, can here arise. Thus, there is no possibility here of any part of the profit escaping taxation; or of postponement of collection beyond the term of the installments; or any necessity to examine dealings of third parties or go beyond vendor's own books and records.

In a word, the straightforward application of the plain terms of section 44 raises no special problems, in this *third* category, whatsoever. The Regulation should be interpreted accordingly, and not subjected to grossly artificial distortion and stretching of its language, in complete disregard of its purpose and intent, to cover the instant case.

2. If, however, the Regulation here involved were not given a reasonable construction, but interpreted as contended for and here applied by the Commissioner, it would clearly be invalid, because of direct conflict with the express provisions of sec. 44.

(a) The Regulation directs that the excess of each mortgage over the vendor's basis be counted as part of the "initial payments" in the year of sale. The statute, sec. 44, however, specifically excludes from "initial payments" any part of the indebtedness of the purchaser. Where there has been an assumption, this provision of the Regulation has nevertheless been sustained by the courts on the ground that the statute refers to indebtedness of the purchaser *to the vendor,* whereas the as-

suming grantee has an indebtedness to a third party. In the present case, however, there is no assumption and no liability of the purchaser to the mortgagee Bank. The purchaser contracted to pay over the entire selling price, undiminished by the amount of the mortgage, directly to the respondent vendor. *All* of the selling price, including, specifically, the "excess" of mortgage over seller's base, is thus part of purchaser's indebtedness *to the vendor;* and the conflict with the statute is inescapable.

(b) If the Regulation were interpreted as contended for and here applied by the Commissioner, a part of each installment payment actually received, or entire such installments, would be excluded from consideration (*supra,* p. 14). This is directly contrary to the specific mandate of sec. 44, which requires that a uniform percentage of "the installment payments actually received in that year" be returned as income. The Commissioner's conduct in this regard has no authorization in the provisions of the Regulation; but if the latter be interpreted, nevertheless, to justify such procedure, it would thus be in direct conflict with the plain language of the statute.

3. Respondents strongly urge, however, that it is not necessary to invalidate the Regulation. It is elementary that a regulation should be construed in harmony with the statute to which it relates, and that, where possible, a construction should be adopted which avoids invalidity, or grave doubts upon that score. Here, there is a simple, logical interpretation of the Regulation, the interpretation contended for by respondents, and adopted by the Tax Court below, which does no violence to the statute, raises no doubts of its validity, involves no dis-

tortion of the words of the Regulation, and is in harmony with and fully carries out the purposes of both the Regulation and the statute. It is urged that, under such circumstances, this is the interpretation that must here prevail.

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## ARGUMENT.

### POINT I.

### THE INSTALLMENT SALES INVOLVED IN THE PRESENT CASE ARE NOT WITHIN THE TERMS OR RATIONALE OF REG. 111, SEC. 29.44-2.

Section 44 of the Internal Revenue Code of 1939, the basic statute here involved, reads, so far as pertinent, as follows:

> "Sec. 44—Installment basis——
>
> (a) Dealers in personal property
>
> Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.
>
> (b) Sales of realty and casual sales of personalty
>
> In the case . . . (2) of a sale or other disposition of real property, if . . . the initial payments do not exceed 30 per centum of the selling price . . . , the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner pre-

scribed in this section. As used in this section the term 'initial payments' means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made."

The general purpose of the above statute was unquestionably to space the return of profit from the sale evenly over the whole period of the installments. The Commissioner, petitioner in the present case, however, contrary to all precedent, is attempting to require the entire profit on the whole contract, which by its terms was spread over a period of 20-25 years, to be concentrated within approximately the first 27 months thereof. In order to accomplish this result, he is attempting—without precedent in the cases—to exclude from consideration a portion of each installment actually received, or the whole of such installment. In so doing, the petitioner's action purports to be based on Regs. 111, Sec. 29.44-2, which, so far as here pertinent, reads as follows:

> "In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included, as a part of the 'selling price,' but the amount of the mortgage, to the extent that it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the 'initial payments' or of the 'total contract price,' as these terms are used in section 44, . . . and in this section."

If applicable in the present case, the above Regulation would likewise require, as its terms have been interpreted, that the excess of each mortgage over the vendor's basis,

be returned as part of the "initial payment" under the contract; and the petitioner has so treated the contracts here involved.

The Regulation applies, as will be noted, to situations (a) where the property is *"merely taken subject to"* the mortgage, and (b) where "the mortgage is *assumed* by the purchaser." The present case, however, falls within neither of the above classifications. The mortgages here were *not* assumed, nor, as respondents contend, was property taken "merely subject to" the mortgage, within any reasonable construction of that term as here employed. The present case, as will be shown, belongs to a well recognized *third* category, separate from either of the above. Almost contemporaneously with the promulgation of the Regulation, it was specifically held that its provisions did not apply to a situation such as is here presented (*G.C.M. 3048,* C.B. VII-1, p. 60; *infra,* pp. 53-54. And in the leading case of *Burnet v. S. & L. Bldg. Corp.,* 288 U.S. 406 (considered in detail, *infra,* pp. 51-53), the rationale and practical justification for the Regulation was very thoroughly explored and expounded by the Supreme Court, in terms that are totally inconsistent with the Commissioner's present position. Respondents accordingly contend that the present situation is wholly outside both the language, and the purpose and intent of the Regulation.

(1) So far as the category of property taken *"subject to"* the mortgage is concerned, it may be said that in a broad, general sense, every sale of mortgaged premises is subject to the mortgage, by operation of law. But that is not the *usual* meaning of the term, nor the sense in which it is used in the Regulation. In the very broad

sense, of course, even sales where the mortgage is "assumed" are "subject to" the mortgage; but the Regulation, which is phrased *in the alternative,* obviously never intended this meaning.

In the usual meaning of the term, taking property "subject to" a mortgage indicates that the seller is under no obligation to the purchaser to give the latter a clear title, or to pay off the mortgage; that what is sold is, in effect, merely the equity of redemption; that the mortgage debt is to be satisfied primarily out of the land; and that the price actually paid to the seller, has been reduced by the amount of the mortgage. Thus, *Tiffany on Real Property,* the well recognized and leading authority in this field, declares (3rd ed., vol. 5, p. 364) that, although a transfer of mortgaged property is always subject to the mortgage (except in case of transfer to a bona fide purchaser without notice), "in the sense that the transferee takes the land subject to the possibility that it may, at the instance of the holder of the mortgage, be applied to the satisfaction of the obligations secured by the mortgage," nevertheless

> "The statement in a particular case that the transfer is *'subject to'* the mortgage, *usually* refers *not to the fact that rights of the mortgage creditor take precedence of the rights of the transferee,* but to the relations between the parties to the transfer as regards the duty to satisfy the debt secured by the mortgage. By taking a transfer *subject to the mortgage,* the *transferee concedes that, as between him and the transferor, the debt is to be satisfied out of the land, and that the transferor is not, as being personally liable for the debt, under an obligation to*

*pay it for the purpose of relieving the land in the transferee's hands.*" (Italics supplied.)

In the present case, of course, the transfer is decidedly not "merely subject to" the mortgage, in the above "usual" sense of the term. By the terms of the contract, the mortgage debt was *not* to be "satisfied out of the land," and the transferor was *not* relieved of his obligation to pay off the mortgage, for the purpose of relieving the land. On the contrary, the purchasers here were, in every case, entitled, upon completion of their contracts, to receive from the vendors a deed to the property free and clear of the mortgage (R. 47, 67).

Similarly, 4 *Pomeroy's Equity Jurisprudence* (1941 ed. pp. 613-614) declares:

> "Where a mortgagor conveys by a deed which states simply that the conveyance is '*subject to*' a certain specified mortgage, or words to that effect, the grantee takes the land burdened with the lien. As between himself and the grantor-mortgagor, the land is the primary fund out of which the mortgage debt should be paid; *he cannot claim that the mortgagor should pay off the mortgage and exonerate the land.*" (Italics supplied.)

To the same effect, see:

> *Fogarty v. Hunter,* 83 Ore. 183, 162 Pac. 964, 971.
>
> *Henry v. Heggie,* 163 N.C. 523, 79 S.E. 982.
>
> *Scale v. Berryman,* 46 Ariz. 233, 49 Pac. (2d) 997.

As the Court declared, in *Clark v. Thompson,* 83 F. Supp. 133, 136:

> "A conveyance of land '*subject to* a mortgage' is a simple deed of whatever interest, estate or equity the

grantor has *after the debt is satisfied out of the property.*" (Italics supplied.)

Furthermore, where property is sold "*subject to*" a mortgage, *the price actually paid to the vendor is regularly reduced by the amount of the mortgage.* See Tiffany, *supra,* sec. 1435, p. 365 (R. 136-7).

And as the Court pointed out in *Carpenter v. Koons* (20 Pa. St. 222, 227):

> "There is a palpable difference between one who buys land *subject to* a mortgage, and *has a reduction in the price equal to the amount of the lien,* and another who pays its full value and stipulates for a title clear of encumbrances."

The sharp distinction between the present case, and sales "subject to" a mortgage, as that term is used in common parlance, and by the above authorities, needs no further emphasis.

(2) It should be noted in this connection that the two categories mentioned in Reg. 111, Sec. 29.44-2 (c) are *not* all-inclusive. As Tiffany declares (*Tiffany on Real Property,* 3rd ed., vol. 5, p. 364):

> "The transfer of the mortgaged land may be merely '*subject to*' the mortgage, or it may be accompanied by an agreement on the part of the transferee to pay the mortgage debt, a contract of *assumption,* as it is frequently called, *or it may be neither.*" (Italics supplied.)

Similarly, *Osborne* in his *Handbook on the Law of Mortgages* (1951, p. 695) points out:

> "Terms upon which a mortgagor may sell his interest in mortgaged property are *three.*

> "1. The purchaser may pay to the mortgagor *only the agreed upon value of the redemption interest, i.e., the difference between the amount of the mortgage debt and the amount set as the total value of the land.* He may not, however, assume any personal responsibility for the payment of the mortgage debt. He takes, as it is said, '*subject to*' the mortgage . . .
>
> "2. The purchaser may pay to the mortgagor, as in the first transaction, only the value of the redemption interest. In addition the purchaser may promise the mortgagor to pay off the mortgage debt. Such promises are referred to as *assumptions* of the mortgage . . .
>
> "3. The purchaser may pay the full value of the land, as agreed upon, free from encumbrances. The mortgagor in return agrees to pay off the mortgage debt when it comes due . . ." (Italics supplied.)

The present case, obviously, falls within the third classification thus set out—and *not* within the first, or "subject to" classification.

Similarly, in the leading article on "*Transfers of Mortgaged Property,*" by *Professors Storke and Sears,* 38 Cornell Law Quarterly, p. 185, the authors declare (pp. 188-189) that "Once the parties have decided to let the mortgage ride, they have *three standard methods* of handling the sale." (Italics supplied. ) The authors call these three methods "Grantor-to-Discharge," "Grantee-to-Discharge," and "Grantee's Option." They declare that "the characteristic feature of the Grantor-to-Discharge transaction is the payment of the *full basic bargain price directly by the buyer to the seller.* A buyer who buys in this way, of course, relies on the seller to dis-

charge the mortgage;" and they distinguish it from the other two methods, where "the buyer pays *only the equity price to the seller.*" The "standard name" of the "Grantee-to-Discharge" method, they declare, is "*assumption* of the mortgage" (p. 190). In the method called by them "Grantee's Option," the grantee "incurs no personal liability. No personal duty to discharge the mortgage arises either from buyer to seller or from seller to buyer. The buyer has a choice, or option: he may pay off the mortgage and keep the land, or simply let the land go upon foreclosure, limiting his loss to the equity price. . . . This transaction is *usually* called '*transfer subject to the mortgage* . . .'" (p. 190; italics supplied.)

Similarly, the article "*Taxing Transfers of Mortgaged Property,*" by *A. D. Lurie,* 39 Cornell Law Quarterly, p. 611, points out the *three* different methods of transfer of mortgaged property, and adopting the terminology of Professors Storke and Sears, *supra,* declares (p. 614) that the "*Grantee*-to-Discharge is, of course, the familiar transaction of the buyer *assuming* the mortgage, and getting credit in the purchase price for the amount of the mortgage. '*Grantor*-to-Discharge' is employed most frequently in subdivision sales . . ."

Summarizing all the above authorities, whose weight and accuracy may not be questioned, it is clear that while all of them recognize that the term "subject to" may, in a general sense, refer to all sales of mortgaged property, in the sense, that is, that the mortgagee's lien always remains paramount, nevertheless, in the *usual* sense, the term "subject to" refers to a sale of mortgaged premises where the purchaser pays to the vendor, not the full

value of the land, unencumbered by the mortgage, but only the "value of the redemption interest," and the vendor is under no obligation to the vendee to pay off the mortgage debt, or tender a clear title. It is equally clear, that the present case does not fall within this category, and does not present a case of property taken "subject to" the mortgage, in the usual meaning of the term.

(3) The question here presented, therefore, is in what sense is the term "subject to," as employed in the Regulation here involved, to be construed? Is it to be given its *usual* meaning, as defined by Tiffany and the other authoritative sources cited above—a meaning which excludes the case at bar? Or is it to be given its broadest conceivable significance, and stretched to include *all* sales of mortgaged property, whatsoever?

Respondents respectfully submit that the Regulation, when employing the term "subject to," must be held to have used it in its usual sense, as defined above, and that this conclusion is not only required by well established general rules of interpretation, but even more forcibly, by a consideration of the history and purposes of the basic statute, I.R.C., sec. 44, and of the Regulation itself.

It is very well established, to begin with, that the language of statutes and administrative regulations in general, and tax laws, in particular, should, wherever possible, be given their *usual* and ordinary significance. Thus, in *DeGanay v. Lederer,* 250 U.S. 376, 381, the Supreme Court declared:

> "Unless the contrary appears, statutory words are presumed to be used in their ordinary and *usual*

sense, and with the meaning commonly attributable to them." (Italics supplied.)

Similarly, in *Davis v. Penfield,* (C.C.A. 5-1953), 205 F. 2d 798, the Court declared that "strained and artificial constructions in tax cases of law or of fact will be avoided, and words and acts will normally be given their *usual* and ordinary meaning." (Italics supplied.)

See also *Com. v. Korell,* 339 U.S. 619, 627-8, and numerous cases there cited.

It is superfluous to multiply citations as to the above rule. The gist of it is, that unless there are overriding considerations to the contrary, the words, "subject to" should not be stretched beyond the situation to which, as Tiffany and the other authorities cited above have made plain, they usually and properly refer.

In the present case, not only is there a total absence of any contra-indications to the application of this rule, but every consideration of the policy and purpose of the statute, sec. 44, and of the Regulation itself, overwhelmingly dictates the same conclusion. As will clearly appear, the Regulation had everything to do with cases of assumption, and of "subject to," in the usual sense; in these connections, its purpose was plain, and it served a needed function. But it had nothing whatsoever to do with such a situation as is here presented.

It is here necessary to beg the Court's indulgence for a brief review of the very elements of the foundation and purpose of the installment method of reporting, as set up in sec. 44, and of the Regulation here involved. For while these considerations are elementary, it must be stressed

that they are basic and essential to the question in the present case, and that they are considerations of which petitioner has completely lost sight.

Prior to 1926, the situation was handled through departmental regulations, but, after some years, these regulations were held to be without statutory warrant. (*Willcuts v. Gradwohl,* 58 F. 2d 587, 590.) Thereupon, Congress enacted section 212(d) of the Revenue Act of 1926, which is substantially identical with I.R.C., sec. 44, quoted above. The general purpose of this statute has been many times stated. As the Supreme Court declared, in *Com. v. South Texas Lumber Co.,* 333 U.S. 496:

> "The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on *the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price.*" (Italics supplied.)

Similarly, in the leading case of *Burnet v. S. & L. Bldg. Corp.,* 288 U.S. 406, 413, the Supreme Court declared that the statute operated to permit the vendor "to distribute the profit *through the years during which purchase money was actually received.*" (Italics supplied.)

Similarly, the purpose of sec. 44 is declared, in *In Re Roger's Estate* (143 F. 2d 695, 696-7), to have been to "spread the profit over the period during which the installment obligations are satisfied or disposed of."

Or, as the Board of Tax Appeals phrased it, in *J. P. Jerpe,* (45 B.T.A. 199, 202), the purpose was to allow the vendor *"to apportion the profit evenly* over the latter payments as they are received." (Italics supplied.)

In order to carry out the above purpose, Congress provided, in sec. 44, that the vendor who elected to return the sale under this method, should return as income in any taxable year ". . . that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price." In other words, the statute set forth a percentage:

$$\frac{\text{Gross Profit}}{\text{Total Contract Price}}$$

which was to be applied to each installment payment actually received, to determine profit returnable therefrom.

In this statutory scheme, "total contract price" meant just what is ordinarily meant by the term, viz., the total amount designated in the contract as the purchase price, and was equivalent to "Selling Price"; and, in all ordinary cases, this statutory scheme operated smoothly and accurately. The statutory percentage represented the rate of profit on the entire contract; and this percentage applied to each individual installment, represented the ratable amount of total profit present in that individual payment; and the total of all such calculations was necessarily equal to the entire amount of profit on the contract. The statutory purpose was thus achieved, of spreading the profit precisely, and evenly, over the entire period of the installment payments; and the entire profit was returned, in the process, directly out of such installments.

It soon became apparent, however, that, in the case of installment sales of mortgaged property, where the mort-

gage was assumed by the vendee, or where the property was taken "subject to" the mortgage (in the usual sense, as set forth above), the statutory scheme met a complication; for, in each such case, the vendee did not pay to the vendor the total contract price, in the usual sense (i.e., the amount at which the contract valued the property, unencumbered by the mortgage)—but only the *difference* between this amount, and the amount of the mortgage. In a word, the "total contract price," as that phrase was customarily used, was *not paid to the vendor;* the selling price, or contract price, was here *different,* and *greater,* than the amount so received. *The amount of the mortgage never showed up in the installments actually paid.*

Furthermore, it was apparent that if this fact was ignored, the statutory percentage prescribed by sec. 44 would necessarily result *in failure to recover all the profit.* Thus, to illustrate, if property, costing \$90,000, with a mortgage on it of \$80,000, was sold for \$100,000, there was a profit of \$10,000. But if the vendee assumed the mortgage, or took the property, *"subject to"* it, in the usual sense, he paid the vendor, in down payment and installments, only \$20,000. And if the vendor returned, of this \$20,000, only the percentage

$$\frac{\$\ 10{,}000\ \ \text{(gross profit)}}{\$100{,}000\ \ \text{(total selling price designated in the contract)}}$$

or 10%; then, his total returns, over the whole period of the installment contract, would only be 10% of \$20,000—or \$2,000; instead of the correct figure of \$10,000 profit.

To avoid this incorrect result, and to carry out the purposes of sec. 44, and reach all the profit, the Commis-

sioner, shortly after the enactment of the statute in 1926, promulgated Reg. 69. art. 44, which provided:

> "In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall not be considered as part of the 'initial payments' or of the 'total contract price' but shall be included as part of the 'purchase price,' as those terms are used in section 212 (d) . . . and in this Article."

In brief, inasmuch as, in the two situations dealt with, the amount of the mortgage was *not paid to the vendor,* it was excluded from "total contract price." This resulted in a statutory percentage that, in most cases of sale of mortgaged premises, cured the discrepancy above noted. Thus, in the illustration above given, the statutory percentage would, in accordance with the Regulation, be fixed at

$$\frac{\$10{,}000 \quad \text{(gross profit)}}{\$20{,}000 \quad \text{(total contract price; i.e., \$100,000 selling price, less \$80,000 mortgage)}}$$

or 50%; and 50% of the $20,000 actually received by the vendor in the installments, would be $10,000—the correct figure for total profit.

The purpose of the Regulation, in its origin, was thus to ensure that the application of the statutory percentage, to installments actually received, did not result in failing to tax *all* the profit. It was merely a necessary explication of the statute, to permit the retention of the statutory percentage, and at the same time, recover all the profit, over the life of the installments, and directly from them.

After some years' experience under the new statute, however, it became obvious that there was still one situation where the Regulation failed to effectuate the statutory intent; viz., that all of the profit realized on the sale should be returned during the period of the installments; and that part of the profit escaped return by this method. This occurred in the case of the so-called "excess" mortgages—i.e., where there was a mortgage in excess of the vendor's base, and the mortgage was assumed by the vendee, or the property taken "subject to" it, in the usual sense. Thus, if property costing $70,000, but mortgaged for $80,000, was sold for $100,000, on the installment plan, the purchaser assuming the mortgage or taking "subject to" in the usual sense, then the total profit would be $30,000; the "total contract price," as specified in the new Regulation, would be $20,000; and the statutory percentage would be 100% plus. But even 100% of the payments actually received by the vendor from the vendee would be only $20,000—and $10,000 of the $30,000 total profit, would still fail to be returned by this method.

In a word, the $10,000 "excess" of the mortgage over the base, not being included in installments actually paid by the vendee to the vendor, would escape taxation. At least, it would not be reached in accordance with the scheme of sec. 44.

To plug up this loophole—and for no other purpose—the Regulation was amended in 1929, so as to present substantially the wording of Reg. 111, Sec. 29.44-2, *supra*, p. 21 (*T.D. 4255*, C.B. VIII-1, p. 165), which reaches this "excess" profit, by including it in the "initial payment."

It is apparent from the above review that the Regulation was, to a certain extent, a departure from the method prescribed in sec. 44, but one in *necessary aid* of sec. 44, and that it was promulgated to take care of certain situations where the statutory scheme broke down. *But none of these considerations have any application whatsoever to a situation like the case at bar!* Here, the entire amount of the selling price *is* paid directly to the vendor by the purchaser, via the installments (and down payment); and, consequently, the plain and straightforward application of the statutory scheme, as set forth in sec. 44, recovers *all* the profit realized from the contract, and does so over the period "during which the purchase money was actually received" (*Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406, 413, *supra*), and directly *from* the "installment payments actually received in" the year involved—precisely as the statute contemplates. *There is no special problem here to be dealt with whatsoever!*

Thus, in the present case, where the houses sold for approximately \$4,500, and there was a mortgage of approximately \$4,000, and a basis to the vendor, respondent, of approximately \$3,500, there was a profit of \$1,000. Applying the statutory scheme, precisely as it was written in the statute, and as it is applied in any ordinary case, with no distinction between "selling price" and "total contract price," the statutory percentage is:

$$\frac{\$1{,}000 \quad \text{(gross profit on entire contract)}}{\$4{,}500 \quad \text{(total contract price = selling price)}}$$

or 22.222%; and applying this figure to the total of "installment payments actually received" during the life of the contract—which is \$4,500, the full selling price—one

gets $1,000—the correct and full amount of profit to be returned.

Obviously, the present case is not the *usual* case of transfer of mortgaged property, contemplated by the Regulation, and giving rise to the special problems dealt with by the Regulation; and on well settled principles of construction, the Regulation should not be forcibly construed to cover it. (*Cf. Com. v. Henry Hess Co.,* 210 F. 2d 553, 559, where this court, construing the Treasury Regulation there involved, held that it did not apply to the case then before it, because "This is not the *usual* case contemplated by the Regulation.") (Italics in original.)

The Commissioner's brief herein, however, completely ignores all the considerations of rationale, purpose and intent of the Regulation, as set forth above, and as clearly expounded in the *S. & L. Bldg. Corp.* case by the Supreme Court (*infra,* pp. 51-53). It pays no heed to the natural reading of the language, its usual meaning and intended function, but rigidly insists upon the broadest possible meaning for the phrase "subject to," regardless of the total lack of *reason* for such a reading, and regardless of needless conflict thus caused with the whole basic purpose and scheme of sec. 44.

Treasury regulations are valid and effective, as the Court declared in *Philadelphia Elec. Co. v. U.S.* (117 F. Supp. 424, 427), "where they are reasonably designed to carry out the intent of Congress, but they cannot add a condition to a right which Congress did not impose, *unless the addition was necessary in order to make effec-*

*tive the conditions imposed by Congress. Helvering v. Credit Alliance Corp.,* 316 U.S. 107, 113; *Helvering v. Reynolds,* 313 U.S. 428; *Campbell v. Galeno Chemical Co.,* 281 U.S. 599, 610; *Eastman Kodak Co. v. U.S.,* 48 F.S. 357."

In the present case, any departure from the statute was 100% *un*necessary, and the force of the rule set forth in the above quotation needs no comment.

(4) So far as the category of *assumed* mortgages is concerned, it is likewise clear that the present case does not fall within the scope of the Regulation. Petitioner's brief argues, in effect, that because purchasers were required by their contracts to make payments to the respondent vendors, calculated in amount with reference to sums due by respondents on the mortgage, and the vendors in turn are obligated to the purchasers to pay off the mortgage, this constitutes an "assumption" by the purchasers. Such is not the law. These provisions of the contracts herein, copiously insisted upon in petitioner's brief, merely bring the case within the *third* category of standard methods of transfer of mortgage property, which, as has been seen, is an entirely different category from "assumption" (*supra,* pp. 25-28). In this third category, payment of the full price, undiminished by the mortgage, is made directly by the purchaser to the vendor —*not* to the mortgagee; and the provisions in the present contracts, requiring vendor to make payments on the mortgage, on which so much stress is laid by Petitioner's brief, are no more than an express implementation of what the law, in this "third category," in any event requires of the vendor. Thus, Professors Storke and Sears,

in their above cited article (*supra,* p. 26), declare, as already quoted, that in the "Grantor-to-Discharge" type of transaction, where the buyer pays the full price directly to the seller, "A buyer who pays in this way, of course, relies on the seller to discharge the mortgage." Similarly, *Tiffany on Real Property* (3rd ed.), vol. 5, p. 365, declares that ". . . if the full agreed value of the land was paid, it may be concluded that the parties intended *the grantor to pay the mortgage debt out of the proceeds of the sale.*" (Italics supplied.)

Similarly, *Glenn, Mortgages* (1943), vol. 2, p. 1142, declares that if the vendee has paid the full price, without any deduction, he may, as a matter of law, look to his vendor for protection against the mortgage lien.

It is, of course, of the essence of an "assumption" that there be a personal liability of the purchaser to the mortgagee. This is established by innumerable authorities:

> 59 *C.J.S., Mortgages,* sec. 418, p. 615;
> *Tiffany, Real Property,* 3rd Ed., vol. 5, p. 372;
> *Everts v. Matteson,* 21 C. 2d 437, 447.

This is, indeed, conceded in Petitioner's brief, p. 53, where Petitioner speaks of "the issue of whether a purchaser of mortgaged property, takes subject to the mortgage . . . or *assumes* (viz., *incurring personal liability to the mortgagee* . . ." (Italics supplied.)

But, in this "third category" of methods of transfer of mortgaged property, obtaining in the instant case, there is no such liability of purchaser to mortgagee. Thus, in the above cited article by Professors Storke and Sears, it is declared (38 Cornell Law Quarterly, p. 199), that:

> "In a Grantor-to-Discharge transaction, the grantee is only a *real* surety, never a *principal and never personally liable.* (Osborne, Mortgages, 248(3) 1951)" (Italics supplied).

(A "real" surety being defined, *id.,* p. 193, as one who has no *personal* liability, but whose liability is limited to certain property owned by him.)

Cf. *Ayers v. Makely,* 131 N.C. 60, 42 S.E. 454.

In the present case, indeed, the conceded facts make the absence of purchaser's liability especially clear. The intent that the purchaser shall *not* presently assume, appears incontrovertibly from the very face of the contract. For it provides, as stated above, only for a *possible future* assumption, 2 to 12 years hence (R. 126; *supra,* pp. 7-8) which is quite incompatible with any intent that there should be a present assumption. As the Tax Court declared, (R. 135):

> "The foregoing provisions of the agreement makes it clear that there was no assumption of the mortgage when a property was sold by petitioners. As is clearly stated, the buyer agreed to assume the mortgage upon conveyance of the property by the seller at some time from 5 to 12 years after the first-period installments had been made. The regulation has no application until there is an actual assumption."

And, to repeat, the option to take title and assume, at such future date, was *in no case* exercised (*supra,* p. 8). Consequently, they play no part in this case.

*Helvering v. San Joaquin etc. Co.,* 297 U.S. 496;
*Lucas v. North Texas Co.,* 281 U.S. 11;
*C. A. Cochran,* 23 B.T.A. 616, 619.

The intent, obviously, was for purchaser to become liable to the mortgagee Bank, only when and if, years hence, he took title and *then* assumed. Furthermore, the document actually signed in preparation for this possible contingency was not an assumption, but a mere guarantee to the Bank, which, even if it ever came into operation, would still have left the respondent vendors primarily liable (R. 127, 31),—a circumstance which, in itself, is utterly irreconcilable with the claim of assumption; for it is elementary that it is of the essence of an assumption that, as between the parties, the *purchaser* becomes primarily liable.

Petitioner's brief lays heavy emphasis upon the various documents, including the so-called "Purchaser's Certificate," signed by purchaser, in connection with the contract of sale; but far from indicating any present intent to assume, these documents, so far as they are relevant at all, indicate precisely the opposite. As already shown (*supra*, pp. 7-8), these papers were prepared only for use in a possibly *future* contingency which never materialized, and which, by the terms of the contract, could not arise for from 2 to 12 years hence (*supra*, pp. 7-8). The loan to respondents from the mortgagee Bank was complete long before the purchaser appeared in the transaction; and so far as the F.H.A. was concerned, by the very terms of the document cited (viz., "Consent to Substitution of Mortgagors under Title VI"), which contained the "Purchaser's Certificate," it *could not* come into immediate effect, for prior payment of at least 10% of the F.H.A. valuation, or the purchase price, was a prerequisite (*supra*, p. 10). And to repeat, in the actual event, it *never* took effect.

All of these considerations, indeed, were so clear to all concerned, that, in the Tax Court below, it was *conceded* that there was, at no time, any liability of the purchasers herein to the mortgagee Bank, and so stipulated (R. 136, 30, 55-56). And in the here manifest absence of such liability of the purchaser to the mortgagee, it is assuredly idle to speak of "assumption."

Furthermore, it has been squarely held—and in connection with a pre-1926 regulation relating to installment sales which was the predecessor of the very regulation here involved—that the type of transfer here involved is not an assumption.

Thus, in A.R.M. 140 (C.B. 5, p. 90) there is embodied a memorandum from the Solicitor of Internal Revenue, dealing with a situation where mortgaged property was sold on the installment plan, the purchaser agreeing to pay a sum stated by a certain date "in accordance with the note and mortgage executed by the parties of the first part to" the mortgagee. The Solicitor held that this did not constitute an "assumption" of the mortgage debt, and should not be treated as such, for purposes of calculating "initial payments" (under the pre-1926 Regulations), declaring:

> "*In the present case, however, it does not appear that the purchaser assumes the mortgage on the property referred to above. He merely agreed to pay an amount to the seller equal to the amount of the mortgage* on or before June ......, 1927, as the final payment on the property." (Italics supplied.)

Similarly, in *Ayers v. Makely*, 131 N.C. 60, 42 S.E. 454, there was a sale of mortgaged premises on the install-

ment plan, and the purchaser agreed to make payments which, under the contract, ''were to be applied to the payment of the encumbrances.'' It was held that there was no ''assumption'' of the mortgage by the purchaser.

Similarly, in *Clinton Park Development Co.,* 11 T.C.M. 768, aff'd., 209 F. 2d 951, sales of houses covered by a mortgage, in a war-time real estate subdivision, were made, and the contracts provided that the purchasers should pay certain amounts weekly to the vendor, of which a specified portion should be paid by the vendor on the mortgage debt. It was held by the Tax Court that the vendor ''did not pass the burden of the mortgage to the purchaser at the time the contract was signed.'' (11 T.C.M., p. 770), and the Circuit Court pertinently declared, on affirmance:

> ''The benefits and burdens of ownership did not pass from the taxpayer to the grantees at the time of the execution of the agreements.'' (209 F. 2d, at p. 953.)

(5) The law is thus very well established that, in the type of sale here present, there is no assumption of the mortgage debt by the purchaser. Petitioner's brief, nevertheless, argues that, whatever the general law may be in this regard, a special rule obtains in California, under which the present facts do constitute an assumption. This claim of a special California rule is, however, without merit. The well-known California cases cited by petitioner merely restate the general rules obtaining widely throughout the other various jurisdictions and in no way affect the conclusions reached in the preceding pages.

Thus, Petitioner's brief relies on the doctrine of various California cases that an assumption may be implied

from the intent of the parties.[7] But this avails petitioner not at all, for, as has been amply demonstrated above, the clear intent of the parties was precisely to the contrary (*supra*, pp. 39-41).

Similarly, petitioner's brief relies on the doctrine set forth in *Hopkins v. Warner*, 109 Cal. 133, to the effect that "the purchaser's personal liability to the mortgagee springs from the well known rule in equity that a creditor is entitled to the benefit of any obligations or securities given by his debtor to one who has become a surety of such debtor for the payment of the debt" (Pet. Br., p. 23). But this statement (which is by no means a special California doctrine, but merely a common rationale for purchaser's liability to the mortgagee), likewise is of no avail to Petitioner, to establish an assumption herein. It merely describes a *result* of assumption, when there has been such; and depends, for its application, upon a prior agreement of the grantor and grantee that, as between themselves, the latter shall be the primary debtor, and the former merely a surety. *Hopkins v. Warner, supra*, 109 Cal. at pp. 135-6; *Keller v. Ashford*, 133 U.S. 610, 613, (cited in the *Hopkins* case), where the Supreme Court declared: "In short, if one person *agrees with another to be primarily liable* for a debt due from that other to a third person, so that as between the parties to the agreement the first is the principal and the second the surety,

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[7]As a matter of fact, some years prior to the time the contracts herein involved were executed, the law had been materially changed in this regard in California, by statute, which requires that assumption shall be specifically provided for in the conveyance. *Cal. Civ. Code*, Sec. 1624. But respondents have no need to rely upon this or similar statutes.

the creditor of such surety is entitled, in equity, to be substituted in his place for the purpose of compelling such principal to pay the debt.'' (Italics supplied.) In the present case, as has been repeatedly brought out, nothing of this sort occurred. On the contrary, the purchaser contemplated only a possible *future* assumption and, even then, in the transaction as actually carried out, would have become only a gurarantor, and never ''primarily liable'' (*supra,* p. 40).

Similarly, petitioner is not aided by the statement quoted from *White v. Schader,* 185 Cal. 606, 611, that ''where the payment of a mortgage forms part of the consideration for a conveyance . . . the grantee is bound to pay the same.'' This language, which is a very common formula, does not refer to payment of the amount of the mortgage *to the vendor,* as in the present case, and in all cases of this ''third category,'' but, as exemplified in the facts and statements in innumerable cases using the above phrase, means that the amount of the mortgage, though counting as part of the purchase price, is *deducted* from what is paid the vendor, and is to be devoted, instead, to paying off the mortgage. This appears in the very cases cited in petitioner's brief, and in authorities relied upon by such cases.

Thus, Pomeroy's Equity Jurisprudence, sec. 1206 (cited in *Hopkins v. Warner,* Pet. Br., p. 54), declares:

> ''Sec. 1206. *Grantee assumes the mortgage.* The mortgagor may not only convey the premises 'subject to' the mortgage; he may also convey them in such a manner that the grantee assumes the payment of the mortgage debt, and thus renders himself liable therefor. The element which lies at the bottom of such

> assumption, and which alone gives it efficacy according to the theory held by some courts, is the fact that *the mortgage debt is included in the purchase price as a constituent part thereof, and the grantee actually pays or secures to his grantor only the balance of the gross price after deducting such debt.*" (Italics supplied.)

Similarly, in *Brosseau v. Lowy,* 207 Ill. 405, 70 N.E. 901, relied on in *White v. Schader, supra,* (Pet. Br. p. 54), only a part of the consideration was paid to the vendor; and the Court there relies upon the case of *Thayer v. Torrey,* 37 N.J.L. 339, where, again, the amount of the mortgage was *deducted* from what was paid directly to the vendor, and the Court, after declaring that "the mortgage . . . is to be paid as part of the consideration," declares further: "*Instead of paying him* (the vendor) the entire *consideration money, out of which the mortgage may be paid,* so much of the consideration as may be needful is appropriated by the parties for that purpose."

Similarly, *Wiltsie* on *Mortgage Foreclosure,* (5th ed.), vol. 1, p. 220, declares that "where . . . the amount of the mortgage represents a portion of the purchase price, *the grantee paying the difference between such amount and the agreed price,* there is, in the absence of an apparent intent to the contrary, an implied agreement on the part of the grantee to pay the mortgage." (Italics supplied.)

Similarly, in all the other cases cited by the California decisions, this general formula uniformly refers to situations where the amount of the mortgage is *not* paid to the vendor. In a word, they have nothing to do with the present situation.

There is thus no substance whatever in petitioner's resort to "California law." It must be noted, however, that the petitioner's whole argument in this branch of his brief, which attempts to establish a personal liability of the purchaser to the mortgagee Bank (Pet. Br., pp. 23, 53 *ff*), is quite out of court, in view of the express stipulation of the parties that no such liability ever existed (R. 136, 30, 55-56), as to which stipulation, petitioner's brief is discreetly silent. The whole question here, moreover, as contended by petitioner's brief (p. 53), is said by him to be "one of intent—viz., a question of fact"; and the stipulation was, clearly, essentially an agreement as to the manifest intent of the parties in this respect (*supra*, pp. 39-41). (*Cf.*, the court's enforcement of the stipulation in *Minneapolis Brewing Co. v. Merritt,* 143 F. Supp. 146).

Furthermore, the attempt of petitioner, at this late date, to introduce a new issue, for the purpose of *reversing* the decision of the Tax Court, is contrary to settled practice, and will not be considered. *Kotteman v. Com.,* 81 F. 2d 621, and authorities there cited; *U.S. v. Waechter,* 195 F. 2d 963; *Homann v. Com.,* 230 F. 2d 671. It is only in "exceptional circumstances" that the rule is relaxed (*Kotteman v. Com., supra*), and none such here appear. On the contrary, it would be grossly inequitable to permit this question, essentially one of fact, by petitioner's own analysis, to be now raised for the first time.

In any event, irrespective of these binding considerations, the intent of the parties that the purchaser should not assume at the time of the sale, is overwhelmingly clear.

(6) Petitioner's brief, further, argues that, whether or not there actually was an assumption of the mortgage debt herein, the transaction, from a "practical" point of view, should be treated as such, because the respondents took a similar "realistic benefit" therefrom (Pet. Br., pp. 20-22, 42-46). There is nothing "practical" about this argument; it is merely confused. The relevant question here, is not whether the two different situations are alike in economic benefit, but *whether they are alike from the point of view of the practical and efficient operation of sec. 44.* And from this crucially important point of view, as already pointed out in detail (*supra,* pp. 31-36) the two situations are totally different in all their vital and essential aspects; *viz.,* in an assumption, the amount of the mortgage *is not paid to the vendor, and never gets into the installments payable to him;* the amount of the payments on the mortgage is not determinable, with certainty, from the vendor's own books, nor are such payments necessarily limited to the period of payment of installments. Furthermore, in an assumption, the vendee becomes directly and primarily liable to the mortgagee. These are the very factors, and the *sole* factors, on the ground of which the Supreme Court in the *S. & L. Bldg. Corp.* case (*infra,* pp. 51-53) and the court in *Lucas v. Schneider,* (47 F.2d 106; *infra,* pp. 61-62), validated the Regulation "in the unusual circumstances presented." They are the whole basis and occasion for the Regulation. But *none of these crucial factors are present in the instant case.*

It is thus merely frivolous to argue that though there may indeed be no assumption here, it is practically the

same thing. On the contrary, the situations differ in just those particulars which are here decisive.

Essentially, the petitioner's argument here is an attempt to apply the doctrine of *Crane v. Com.,* 331 U.S. 1, which deals with the reporting of income for *general* tax law purposes, to a situation where it has no application, viz., the *special* method of reporting permitted by sec. 44. The *Crane* case will be considered in detail in Point III, (*infra,* pp. 74-80). At this point, it is sufficient to note that the very reason for the enactment of sec. 44 was to permit taxpayer to *defer* the reporting of what, under generally established principles, was unquestionably present income.

It is simply not true that, under sec. 44, if the "real" benefit is similar, two different situations must be treated alike. Sec. 44 provides a special scheme, available on certain conditions, and whether or not a taxpayer comes within these special conditions, or fails to do so, does not depend upon the equivalence of the two situations from the point of view of economic benefit. Thus, e.g., from the point of view of practical benefit, it might be held that the obligation of purchasers on an installment contract are "in effect" equivalent to cash (at least to the extent that they have a fair market value). Such, indeed, is the general law. But nevertheless, it is *not* treated, under sec. 44, in the same manner. Even if evidenced by notes, secured by ample independent collateral, and thus "realistically" indubitably "the equivalent" of cash, they cannot be so treated, under sec. 44. *R. L. Brown Coal & Coke Co. et al,* 14 B.T.A. 609, 614; *Mertens, Federal Income Taxation,* vol. 2, p. 478.

To sum up: sec. 44 extends a privilege. In the usual types of transfers of mortgaged property, the exercise of the privilege is circumscribed, necessarily circumscribed, in accordance with the present Regulation, by the practical difficulties in the application of the statutory scheme. In the type of sale in the present case, whether or not it is economically similar, no such complications arise, and there is therefore no reason why respondents should be denied the full and uncurtailed measure of relief extended by the statute.

Petitioner's final suggestion is that the Regulation should be construed to apply by its terms to *all* transfers of mortgaged property whatsoever, whether or nor they fall into the category of "merely taken subject to," or "assumed"; that these are mentioned merely "by way of illustration" (Pet. Br. p. 63). This, too is a wholly new issue, not advanced in the court below, and, indeed, never thought of or mentioned by anyone in any of the cases concerning the Regulation in all the years since it was promulgated. It is a mere afterthought, not properly before this Court at this time (*supra*, p. 46).

It is, in any event, without substance. It is wholly inconsistent, of course, with *G.C.M. 3048* (*supra*, p. 22), and a palpably artificial and unnatural reading. It is an elementary canon of construction that general words are to be limited by their context to the more restricted application indicated by the provision as a whole.

Thus, 82 *C.J.S.* 657-8 declares that "the meaning of words of general import in a statute is limited by words

of restricted import immediately following and relating to the same subject." See also:

*St. Luke's Hospital v. Godet,* 171 Misc. (N.Y.) 7, 11 N.Y.S. 2d 900;

*Application of Rogers,* 229 F. 2d 754 (9 Cir.; revd. on other grounds, 350 U.S. 809);

*Jefferson v. U.S.,* 77 F. Supp. 706, 712;

*U. S. v. Fed. Power Comm.,* 191 F. 2d 796, 802, 25 R.C.L., p. 971.

In the present case, as has been shown, the whole purpose and justification for the Regulation lay in the difficulties encountered in attempting to apply sec. 44 to transfers where the mortgage was "assumed," or taken "subject to," in the usual sense, because, in these categories, the *entire* selling price is not included in the "installments actually received" by the vendor, and that, for this reason, the Regulation is not to be construed as here applicable. Precisely the same considerations, which foreclose the adoption of the broadest possible meaning for the phrase "subject to," (*supra,* pp. 28-36) operate to foreclose the present attempt of petitioner to widen the scope of the Regulation. It would be, indeed, senseless, to adopt the "usual" meaning of "subject to," because this is the meaning in harmony with the purpose of the Regulation and of the statute—and then adopt petitioner's present argument.

So far as petitioner's stress on "every sale of *excess* mortgage realty" in this connection is concerned (Pet. Br., p. 62), the reason for the amendment of the Regulation, relating to "excess" mortgages, was stated very clearly by the Supreme Court in the *S. & L. Bldg. Corp.*

case (*infra,* pp. 51-53); viz., that such excess was, indubitably, part of the profit on the entire sale, but was *not* part of the "installments actually received" by the vendor, and "would never, actually, come into vendor's hands." That was the sole ground on which the Supreme Court justified the regulation in this respect, as a necessary and practicable way to reach the profit. But in the present case, as has been pointed out, nothing of the sort obtains. Here, there is no possible escape of profit or postponement of collection. *All* of the amount of the mortgage, including the "excess," is included in the "installments actually received," and is reached, in due course, by operation of the plain provisions of sec. 44, precisely as intended thereby.

(7) The leading case upon the purpose and validity of the Regulation is *Burnet v. S. & L. Bldg. Corp.,* 288 U.S. 406. Here the Supreme Court authoritatively and carefully discussed the considerations which gave rise to and justified the Regulation. In that case, there was a sale of property with an "excess" mortgage, which the purchaser assumed, making payments directly to the mortgagee. The Court sustained the Regulation, but upon grounds which clearly exclude the present case from its rationale and justification. It pointed out that in general the installment method of reporting allowed the vendor "to distribute the profit through the years when the purchase money was actually received," but that the method of reporting income contended for by the taxpayer (which involved basing the tax, not solely upon installments actually received by the vendor, but upon payments made by the assuming grantee to the mortgagee,

as well) *"would inevitably lead to many practical difficulties, might postpone collection far beyond the time when the vendor would receive any direct payments; and probably would render impossible determination from the taxpayer's own books of what he should account for."* (p. 414, italics supplied.)

As to the inclusion of the excess of mortgage over vendor's base, as part of the "initial payments," the Court pointed out that this excess "represented part of the admitted profit," but, under the circumstances of the case then before it (an assumption), *"would never actually come into the vendor's hands,"* and the Commissioner's treatment was therefore "appropriate in the *unusual circumstances* presented"—"a practical way to accomplish the end." (pp. 414-415, italics supplied.)

The gist of the decision was that "some possible departure from the method prescribed for ordinary circumstances is not enough to destroy what he [the Commissioner] deemed *necessary to meet the unusual conditions."* (p. 414, italics supplied.) In the present case, however, as explained in detail in the above pages, we are dealing with "ordinary circumstances," and there is no need for special measures "deemed necessary to meet unusual conditions." For the existence of a mortgage does not in any way complicate the transaction, so far as the operations of sec. 44 are concerned, *except where it has the result of causing less than the full purchase price to be paid to the vendor.* (*supra,* pp. 31-36.) This was the situation, in the case before the Supreme Court. It is not the situation in the instant case, which raises not a single one of the difficulties adverted to in the Court's opinion.

Finally, it is to be noted that the procedure followed by the Commissioner in the *S. & L. Bldg. Corp.* case, and there validated by the Supreme Court, held *"total contract price"* to be *"the total amount payable directly to the vendor"* (p. 412; italics supplied). This, of course, is precisely the contention of respondents herein.

(8) The precise point here at issue has been directly passed on only twice; first, in *G.C.M. 3048* (C.B. VII-1, p. 60, Jan.-June, 1928); and second, by the Tax Court below in the instant case. It is striking that in both these instances the Regulation was held not to apply.

The holding in *G.C.M. 3048, supra,* which is especially significant as having been rendered in 1928, almost contemporaneously with the promulgation of the Regulation in 1926, is well summarized by the Tax Court in its opinion, as follows (R. 137-138):

> "The position taken by respondent (Commissioner) here appears contrary to G.C.M. 3048 (C.B. VII-1, p. 60, Jan.-June, 1928), where it was ruled that the regulation in question was inapplicable. The form of the regulation there involved contained language identical to that before us (viz., 'In the sale of mortgaged property . . . whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser'). The situation dealt with was one where real estate was sold on installments. The purchaser did not assume the mortgage but made monthly payments to the vendor who in turn made the mortgage payments, similarly to the case here. It was held that the rule prescribed in the regulations for the determination of the percentage of profit returnable each year in the case of mortgaged property sold on the installment plan was inapplicable."

Specifically, the above *G.C.M. 3048* held that "so far as the amount of any mortgage is concerned," in the above circumstances, " 'the total contract price' and 'the purchase price' may be regarded as equivalent." Petitioner's brief (p. 48) attempts to distinguish this precedent on the ground that there was a unique arrangement whereby the vendor could encumber the property by mortgage, after the sale, to the extent of the balance due on the contract. But the General Counsel, in the above, specifically declared that "If *prior* to the execution of the contract there was a mortgage against the property, *the same principles apply*" (italics supplied).

Further, the various cases cited in petitioner's brief, dealing with the regulation, do not support his position. Thus the *S. & L. Bldg. Corp.* case, 288 U.S. 406, as has been seen, so far from supporting petitioner, militates, in its whole rationale, conclusively against him. *Lucas v. Schneider,* 47 F. 2d 1006 (see *infra,* pp. 61-62), involved an outright assumption. So, too, did most of the B.T.A. cases cited by petitioner's brief (p. 28), as in the case of *Dabriada Realty Co. v. Com.,* 5 B.T.A. 905, and *Watson v. Com.,* 20 B.T.A. 270. *Bosshardt v. Com.,* 4 B.T.A. 1262, did not even involve a mortgage, at all.

In *Metropolitan Properties Corp.,* 24 B.T.A. 220, the taxpayer raised none of the considerations upon which the respondents here rely, but instead, attacked the validity of the regulation *in toto,* even as applied to an outright assumption, and based his argument upon the decision in favor of the taxpayer, on that ground, in the *Schneider* case in the District Court (unreported). (Brief for pet. in *Metropolitan Properties Corp.* case in B.T.A.,

p. 18.) The Board of Tax Appeals, in its opinion in the *Metropolitan* case, therefore, merely decided adversely to the taxpayer, on the ground that the *Schneider* case (involving outright assumption; *infra,* pp. 61-62) had been reversed in the Circuit Court, declaring: "We agree with the respondent (Commissioner). See *Lucas v. Schneider,* 47 F. 2d 1006, reversing the case relied upon by the petitioner. . ."

None of the points here at issue were raised in the *Metropolitan* case, much less passed on. The case is therefore no precedent in these issues. (See *Montana-Dakota Utilities Co. v. Com.,* 25 T.C. 408, 416, where the Tax Court pointed out: "In any event, it does not appear that the question here was litigated or considered in" the case claimed as precedent. "Accordingly, the case is not to be regarded as authority for the proposition for which respondent stands." To same effect, *Cold Metal Process Co. v. Com.,* 25 T.C. 1333, 1348).

In *Pacheco Creek Orchard Co.,* 12 B.T.A. 1358 (Pet's. Br., p. 28) similarly, the points now raised by respondents did not appear, and were not discussed or passed on, and this case, therefore, likewise can be no precedent for petitioner. But furthermore, in the *Pacheco* case, it was evident that while the formal written contract did not contain an assumption, in the *actual execution* of the contract the purchaser did assume,[8] and did pay off the mortgage not to the vendor but *directly to the mortgagee* (12 B.T.A.

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[8]This transpired before the amendment of Cal. Civ. Code. Sec. 1624, which invalidated any assumption not specifically provided for in the conveyance.

at p. 1362). It was thus in no way, in the actual execution of the transaction, like the present case.

Even if the facts and holding in the *Pacheco* case had been different, and had supported the Commissioner's present contentions, moreover, this would be of little consequence to the decision of the instant case. As the Supreme Court has declared: "One decision construing an act does not approach the dignity of a well settled interpretation." *U. S. v. Raynor,* 302 U.S. 540, 552; *White v. Winchester,* 315 U.S. 32, 40.

The present case is, essentially, one for this Court to decide upon its merits. Such direct authority as does exist is, as shown above, in favor of respondents;[9] and, above

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[9]The conclusion contended for by respondents, moreover, is in entire accordance with the practical usage and understanding of leading authorities in the accounting field. Thus, *W. A. Paton,* in *Advanced Accounting* (1941), after explaining the regulation respecting installment sales of real property, which require the amount of the mortgage (to the extent that it does not exceed the vendor's basis) to be deducted from the state selling price, in finding the "total contract price," points out situations where the Regulation is inapplicable, and declares (p. 369):

> "It may also be assumed that *where the agreement contemplates final acquisition of an unencumbered property by the buyer* the amount of any lien outstanding at date of sale does not affect the calculation of taxable income." (Ital. supplied.)

It is well to remember, moreover, that while accounting practice is, concededly, not determinative, where opposed to valid mandates of a statute or regulation, it is by no means without significance. As the Federal Court, Second Circuit, has recently well declared (*Com. v. Hirshon Trust Co.*, 1954, 213 F. 2d 523, 528):

> ". . . there is frequently a divergence between the tax laws and generally accepted business concepts. That may well be true, but where, as here, *the statutory pattern of taxation and the language used to accomplish it are both in accord with sound accounting* and business practices, such an argument furnishes no ground for reading the statute otherwise than it is written."

all, the case is to be governed by the purpose and justification of the regulation laid down by the Supreme Court in the *S. & L. Bldg. Corp.* case, *supra,* and, basically, by the provisions and intent of sec. 44 itself.

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## POINT II.

**IF INTERPRETED AS CONTENDED FOR BY THE PETITIONER, THE REGULATION WOULD BE VOID, BECAUSE IN VIOLATION OF THE SPECIFIC PROVISIONS OF I.R.C., SEC. 44.**

Petitioner's brief asserts, at various points (pp. 19, 27) that "The validity of the regulation is not here in question," and "The taxpayers have not questioned the validity of the regulation." These statements can only be explained as unintentionally misleading. There is, indeed, no question of the validity of the regulation, as applied to transfers "subject to" the mortgage, in the usual sense discussed in Point I, *supra,* or where there is an assumption, with grantee paying off the mortgage directly to the mortgagee. But, *if interpreted so as to apply to the type of transfer here involved,* the respondents have contended throughout that it would be void, as in conflict with the plain provisions of sec. 44. Respondents so argued in the Tax Court below (R. 116-117), as the Petitioner's brief itself finally states (Pet. Br. p. 30). The Tax Court, having construed the Regulation in accordance with respondents' contentions, had no need to consider the question of invalidity, if otherwise construed.

It has been shown in Point I that the Petitioner's construction of the regulation violates the whole general intent of sec. 44, and that this departure from the statute

is here wholly unnecessary. But, as will be shown in the present Point II, the regulation, so construed, would violate not only the general intent, but the specific and positive provisions of that section.

The cases are legion which hold that this may not be done. As the Supreme Court declared in *Manhattan Co. v. Com.,* 297 U.S. 129, 134-5, holding invalid the Treasury regulation there involved:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress —but the power to adopt regulations to carry into effect the will of Congress as expressed in the statute. *A regulation which does not do this, but operates to create a rule out of harmony with the statute is a mere nullity. Lynch v. Tilden Produce Co.,* 265 U.S. 315, 320-322; *Miller v. U.S.,* 294 U.S. 435, 439-440, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. *International Ry. Co. v. Davidson,* 257 U.S. 506, 514. The original regulation *as applied to a situation like that under review* is both inconsistent with the statute and unreasonable." (Italics supplied.)

Similarly, it has been held that a regulation has no application where, if applied to the facts then presented, it "would fly in the face" of the statute (*Busch's Kredit Jewelry Co. v. Com.,* 179 F. 2d 298, 300). And in the *S. & L. Building Corp.* case, itself (288 U.S. 406, *supra*), the Supreme Court, as already indicated, was careful to point out, three times in the course of its decision, that,

in the "unusual circumstances" there presented, the regulations "violate no definite provision of the statute."

In the present case, the Petitioner's interpretation of the Regulation comes squarely within the condemnation of the above rule. It flatly contradicts the "definite provisions" of sec. 44 in at least two respects: (1) it violates the express statutory definition of what is to be included within the *"initial payments"* on the contract (*viz.* "payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made"); and (2) it violates the express statutory direction that the taxpayer, reporting on the installment basis, should return "in any taxable year" the statutory proportion *"of the installment payments actually received in that year."* Both of these definite directions are here flagrantly violated; the Petitioner treats as received, and part of the initial payments, what is, in fact, *not* received; and he treats, as *not* received, installment payments, or portions thereof, which, in fact, *are* received.

(1) Turning to the first flat contradiction between the Regulation, as interpreted by Petitioner, and the express provisions of the statute, the definition of "initial payments," the statute, to repeat, directs that there shall be recognized, as part of such initial payments, *only* "payments received in cash or property other than evidences of indebtedness of the purchaser" during the taxable year of the sale. These "payments received in cash or property," moreover, refer, it has been held, *only* to "payments *received from the purchaser* of the land"—and not to other possible kinds of income. *Duram Building Co. v.*

*Com.* (66 F. 2d 253, 254). To the same effect, and approving the *Duram* case, see *G.C.M. 12987,* C.B. XIII-1, p. 206, in which the opinion was rendered by Robert H. Jackson, later Justice of the Supreme Court.)

In spite of these explicit provisions, the Petitioner herein seeks to include, as taxable income, of the year of sale, the entire amount of the excess of the mortgage over respondents' basis of the property sold. As stressed above, the "indebtedness of the purchaser to the vendor," in the present case, covers the entire amount of the mortgage *including the "excess" part thereof.* The part of the profit represented by such "excess" is an integral and essential part of what is owed by the purchaser to the vendor, and stands upon the same footing with respect to the mandate of sec. 44 respecting such indebtedness. It is simply a part of the total debt, directly incorporated, without differentiation, into the regular installments payable under the contract *to the vendor, and the vendor alone.* It is thus plainly and inescapably a part of the "indebtedness of the purchaser," as this term has been interpreted by the courts, which the statute categorically commands may not be included in "initial payments."

Petitioner seeks to include such "excess" as taxable income of the year of sale, although no such amount, or any part thereof, has, in fact, as yet been paid by the vendor to the vendee; that it is represented only by "evidences of indebtedness of the purchaser;" and that it may *never* be paid to the vendor by such purchaser!

This procedure is in fundamental conflict with the whole method of Section 44. As the court declared in *May, Stern & Co. v. Com.,* 181 F. 2d 407, 411:

> "In the South Texas case (*C.I.R. v. South Texas Co.,* 333 U.S. 496) the Supreme Court . . . reasoned that, for the taxpayer who has reported income on the installment basis under sec. 44(a), uncollected balances of installments are recognized, not at the time of the sale, but in the future *when they are collected* and reported as taxable income." (Italics supplied.)

The contradiction between the command of the statute and the action sought to be taken by Petitioner is thus a patent and glaring one. His sole asserted justification is that, regardless of the statute, this is what the Regulation requires, and that the Regulation has been held valid by the courts. As has been shown, the Regulation does *not* require any such procedure, in a situation like that here obtaining; but, assuming that it did, it is equally clear that the Regulation, so construed, would be invalid. For the sole ground upon which the courts have sustained the Regulation, insofar as it requires such "excess" to be included in "initial payments," and reconciled this provision with the specific command of the statute, is one totally inapplicable to the case at bar.

Thus, in *Lucas v. Schneider,* 47 F. 2d 1006, where the validity of this provision of the Regulation was passed upon and upheld, the court held only that the Regulation was valid, in connection with a sale where the mortgage was *assumed,* and the whole ground of its decision was based solely upon this circumstance. The court there reasoned that, although the statute prohibited the inclusion in "initial payments" of any evidence of indebtedness of the purchaser, this language referred to indebtedness of the purchaser to the *vendor,* and did not prohibit

the inclusion, as property received, of evidences of indebtedness of the purchaser to a *third person—the mortgagee;* and that, by assuming the mortgage, the purchaser became so indebted to the mortgagee; and declared (p. 1008) that the assumption of the mortgage by the vendee

> "*was not a promise to pay the seller; it was a promise to the seller to pay the mortgagee.* Its effect in equity was to relieve the seller of any direct liability. As between seller and purchaser, it constituted the seller the surety and the purchaser the principal debtor for the mortgage. *Under the law of Kentucky . . . the purchaser is liable personally to the mortgagee.*" (Italics supplied.)

As is evident, the above case differentiated sharply between, and rested wholly on this distinction between (a) an indebtedness of the purchaser *to the seller* (which, by the terms of the statute, could not be considered as part of "initial payments") and (b) an indebtedness of the purchaser to a third party.

But, in the instant case, there was no such assumption; the purchasers were *at no time,* as is stipulated, under any liability to the Bank (*supra,* p. 41); and the respondents remained at all times primarily liable—indeed (with the exception of the guaranty of the Brookfield stockholders and their wives) *solely* liable (*supra,* p. 12). The purchaser's *only* indebtedness, in the instant case—the only "property" which the vendor received, other than cash paid in down payment and installments—was *to the vendor,* which the statute expressly prohibits from inclusion in "initial payments."

Similarly, in the *S. & L. Building Corp.* case, supra (288 U.S. 406), where the Regulation was likewise upheld, as applied to the "unusual circumstances" then presented, the court was likewise dealing with a sale where the mortgage had been *assumed;* and, as already indicated (*supra,* pp. 51-53), stated that the Commissioner's procedure with respect to the "excess" mortgage, was there necessary to ensure that the entire profit be taxed during the period of direct payments to the vendor—whereas, in the present situation, as explained in detail in Point I, there is no such necessity; the normal application of the statute, according to its plain and specific provisions, completely covering the situation.

In a word, the sole ground and rationale on which the courts have determined that the provision of the Regulation requiring the inclusion of "excess" mortgage in "initial payments" does not affront the statute, is here utterly absent; and the statutory prohibition applies directly and without qualification. If construed as Petitioner contends, so as to apply to the situation here presented, the Regulation "flies in the face of the statute," and does so without need or practical justification; and must therefore be held invalid.

(2) Equally striking is the direct conflict between Petitioner's interpretation of the Regulation, and the specific direction of sec. 44, that the vendor return, as income from an installment sale in any taxable year, the stated proportion *"of the installment payments actually received in that year."* Instead of following this perfectly specific and perfectly plain mandate, the Petitioner

in the present case takes the stated proportion of *only a part* of the installment payments actually received, and totally excludes the remainder from consideration.[10]

The amount of actual cash payments by the purchaser to the vendor which the Petitioner's legerdemain causes to disappear from consideration is computed by him according to a rather complex formula viz., petitioner recognizes as received only "the principal portion of the level of payments collected during the period the first 27 installment payments are received over the level of payments prevailing during the remaining term of the contract;" (R. 46-47, 67); but, in substance, he is refusing to recognize as "installment payments actually received," amounts of cash paid to the vendor which are equal to sums that are due, or have been due, by the vendor on the mortgage loan (which the purchaser has not assumed, and on which he has no liability). And since he recognizes, as received, only *the difference in level* of payment between the first 27 payments (which are at the higher level), and those thereafter (i.e., roughly the amount by which the prior installments exceed the latter level), it is evident that, according to his method, after the first 27

[10]Thus, for example, in the year 1943, respondent Stonecrest received, in total cash payments on all sales, $345,348.15; but Petitioner recognized only $77,689.29, (Stonecrest Stip., pp. 21, 24; the figure $77,628.29 representing the sum of "down payments" and "other collections" there shown as recognized by Petitioner)—and thus *excluding* from consideration $267,658.86 of actual cash received. Similarly, in the year 1944, Stonecrest received in actual cash, $297,313.87; but Petitioner recognized only $53,210.20, and excluded $247,624.56 (*id.*). See, for total amounts of installment payments actually received, excluded from consideration by Petitioner, *supra*, pp. 14-15.

payments have been made, *no part whatsoever* of any of the subsequent installments may be recognized at all!

The result of the above is, among other things, that if the contract is performed according to its terms, over a period of 20-25 years of installments, *no installments received in the entire later period of approximately 18 or 23 years,* would be recognized by Petitioner as received—and the whole profit on the entire contract bunched in the first 27 months.

This bizarre and unprecedented—and unjust—result is, in itself, a telling commentary on the unnatural character of Petitioner's construction of the Regulation.

All this "exclusion" by the Petitioner of cash actually received in installments, is, on its face, flatly opposed to Sec. 44, which commands that all installment payments actually received be used in computing the profit for that year; and it violates equally the rule, which is a corollary of sec. 44, that the division of each installment received, into return of cost, and profit, shall be "the same for each installment" (*Com. v. Macklin Corp.,* 164 F. 2d 27, 29).

In the case of a corporation, such as respondent Brookfield, which has engaged in only a single operation and, in a year or two, made numerous sales, the installments on which are to run for a long future period (*supra,* pp. 4, 6) this would result in a situation where vendor would be obliged to sustain expenses of collection servicing, etc., over a long period of time, but would have no income recognized against which to offset such expenses—a grossly unreasonable result, and one opposed to the clear intendment of the installment method of reporting. *J. C. Nichols Land Co. v. Com.,* 65 F. 2d 437, 438.

Nothing remotely like this procedure was present in the *S. & L. Bldg. Corp.* case (or any other case); hitherto, the phrase "installment payments actually received" has meant, as in that case, all amounts actually paid directly to the vendor under the contract. Indeed, the Commissioner's own brief in that case clearly recognized that it was only because the payments there involved were not paid directly to the vendor, that they could be excluded from consideration, declaring (main brief for Comm., pet., in Sup. Ct., after certiorari granted, p. 20) that

> "no inconsistency results from excluding the amounts of the assumed mortgages not in excess of the 'basis' from the 'total contract price' and the payments thereon from 'installment payments actually received, *for payments on such mortgages are not to be made to the taxpayer.*" (Italics supplied.)

But in the present case, the payments *are* to be made to the taxpayer; and this difference is crucial. These payments cannot be excluded, consistently with the statute, from "installment payments actually received."

Nor is there any substance to petitioner's claim that the respondent is a mere "conduit," through which the purchaser's money passes to the Bank (Pet. br. pp. 36, 48). A conduit is one who has no independent interest of his own in the transaction, and is acting merely as an agent of another party or parties. But in the present instance, such a characterization is absurd. Respondents were at all times *personally liable* on the mortgage, and (with the exception of the Brookfield stockholders and their wives) solely liable (*supra*, p. 12). In making payments on the mortgage, they were paying off and

reducing *their own debt* to the Bank. In such circumstances, they had every interest in the transaction—particularly when it is borne in mind that it was a 90% mortgage, and that the purchasers were of very uncertain financial reliability, and realty values precarious (*supra*, p. 3). In a word, this "conduit" characterization is but a flimsy pretext, which in no way justifies disregard of the "installment payments actually received," commanded by sec. 44 to be used as the basis for returning income.

The mere fact that parties have contracted in advance that certain contemplated payments shall be devoted to a specified use, when received, does not make the recipient a "conduit," nor interfere with the recognition of receipt of income. Specifically, the fact that such contemplated payments are to be devoted to *making payments on a mortgage*, does not have any such effect. Thus, in the *Crane* case itself, 331 U.S. 1, the owner—at a time when she had a zero equity in the property—agreed with the mortgagee to devote the rentals from the property to making payments on the mortgage; and did so. But this did not reduce her to a mere "conduit." On the contrary, as appears in the opinion of the Supreme Court, rentals, when received, counted as income of that year.

Again, in *Sterling v. Ham,* 3 F.Supp. 386, the plaintiff sold realty which was encumbered by a mortgage (record title being in the mortgagee, who had foreclosed, without disturbing plaintiff's possession). The total purchase price was approximately $58,000, of which approximately $15,000 was cash and the balance deferred for a number of years. $10,000 of the cash payment, however, was

used to clear the mortgage. The plaintiff sought to report the income from the sale on the installment basis, and the question was, whether the "initial payment" was in excess of the 25 per cent limit then prescribed; and this depended, in turn, upon whether or not the $10,000 cash, supplied by the vendee, but used to pay off the mortgagee, constituted part of the "initial payment." The plaintiff claimed that it did not; that it was no part of his income; and that he was therefore entitled to treat the sale as an installment sale. The Commissioner insisted that it *was* part of the "initial payment."

The court held, first, that the fact that the $10,000 was, as it appeared, actually paid through an attorney to the mortgagee, was of no significance, since the attorney acted as agent for the plaintiff; and the situation was precisely the same as if the payment were "made to him (the vendor) and then passed by him to the mortgagee"; and second, that the $10,000 so paid by the vendee, used for the purpose of clearing the mortgage, *was part of vendor's income* and *was part of the "initial payment" under the statute and the regulations.* The court declared:

> "This contention (of the vendor) cannot be sustained for the reason that the payment to the mortgagee, made at the direction and for the benefit of the plaintiff, had *the same effect as if made to him and then passed by him to the mortgagee.*"

The decision in the *Sterling* case *supra,* is, moreover, in line with a long series of authoritative precedents, establishing the rule that where income is received "the status of the money for tax purposes *did not change*

*because it was agreed that it be devoted to a particular use. Cf. Lucas v. Earl,* 281 U.S. 111." (*Vermont Transit Co.,* 19 T.C. 1040.) (Ital. supplied.) Or, as the court declared in *Standard Slag Co. v. Com.* (63 F. 2d 820):

> "The courts have uniformly held that income is none the less such in the year of its receipt *because subject to limitations* upon its use and disposal." (Citing numerous cases.) (Ital. supplied.)

See also:

> *Charlotte Union Bus Station v. Com.,* 209 F. 2d 586;
> *Bonds, Inc.,* 3 T.C.M. 1197.

The fact that, in the instant case, respondents' use of the payments in question, in connection with the liquidation of their own debt, may likewise have been of benefit to the purchasers, is immaterial; the fact that a payment is "for the mutual benefit of the parties" being no obstacle to the receipt of income (*Brown v. Com.,* 220 F. 2d 12-16).

It is thus abundantly clear that respondents were no mere "conduits," as claimed, and that the "installment payments actually received" by them were none the less so, because of respondents' payments to the mortgagee. This would be true, even if the payments of purchasers to respondents were segregated for a special use; but in the present case, as has been seen, in the actual carrying out of the transaction, which is the test, for tax purposes (*Helvering v. Lazarus Co.,* 308 U.S. 252, 255; *Crane v. Com.,* 331 U. S. 1, 13, footnote 33; *Charlotte Union Bus Station v. Com.,* 209 F. 2d 586) there was no segregation or earmarking; no intended synchronization

of payments by purchasers to respondents, and payments by respondents to the Bank; and the latter payments were out of respondents' own unsegregated general funds, and made prior to and irrespective of the payments, or failure to make payments, of the purchasers (*supra*, pp. 11-12). It is idle, in such circumstances, to allege that respondents were mere "conduits."

Petitioner's brief (p. 49) declares that "the taxpayers made an equitable argument to the Tax Court . . . based on the fact that the Commissioner's application of Section 29. 44-2 of Treasury Regulations 111 results in taxing the entire profit on these contracts within approximately the first twenty-seven months." This, however, is not a mere equitable argument—although the results are, indeed, inequitable; it is a demonstration of the clear invalidity of the Commissioner's procedure.

Petitioner's brief argues, further, (pp. 49-50) that "The short answer to this argument . . . is that the taxpayers themselves arranged the transaction so that their profit would be received within" that period. This is indeed a short answer, but it is not a valid one. When, and in what amounts, the total profit on an entire installment sale is to be considered as realized, for purposes of return of income under sec. 44, depends, not on the private systems of accounting of the parties, or the size of the particular installments, as arranged by them, but solely upon the provisions of sec. 44 itself. The statute, itself, lays down the formula by which installment payments are divided, "part as return of capital, and part to profit" (*S. & L. Bldg. Corp.* case, *supra,* 288 U.S. 406, 413, 414).

If, for example, the parties in the present instance had so arranged, that all of the installments, or amounts equal thereto, were to be applied by the vendor to payments on the mortgage until the latter was completely liquidated, so that only the very last installments were received by seller, with no concomitant obligation to pay out—in such case, the taxpayer would scarcely have been permitted to *defer* report of income, for 20 years!

Petitioner's contention, then, that portions of "installment payments actually received" by respondents or the whole of such installments, may be excluded from consideration, in returning their income for the year in question, is without support in reason or authority, and violates legal precedent no less than common sense. In this connection, we must again stress the rule that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday sense" *(Crane v. Com.,* 331 U.S. 1, 6). And can it seriously be doubted that, in their ordinary sense, the words "installment payments actually received" mean the *whole* of such installments, and the whole of *all* of them? Not a mere part, of some of them! The contracts themselves designate the payments as "installments"; and, nobody in ordinary legal or business transactions, would have the least doubt of this.

Of utmost pertinence here, moreover, is the rule, already referred to in Point I (*supra,* pp. 36-37), that "treasury regulations . . . cannot add a condition on a right which Congress did not impose, *unless the addition was necessary* to make effective the conditions imposed by Congress." *(Philadelphia Elec. Co. v. U.S.,* 117 F.Supp.

424, citing numerous authority; ital. suppl.) In the present case, it must constantly be borne in mind that the gross distortion of the statute contended for by petitioner arises not out of any manner of necessity or practical justification, such as the Supreme Court insisted upon in the *S. & L. Bldg. Corp.* case, and not in aid of the well understood statutory purpose of sec. 44, but in a situation where it defeats that purpose. Respondents submit that it is overwhelmingly clear that, under such circumstances, the construction of the statute contended for by petitioner may not be allowed to stand, and that the Regulation, if so interpreted, would be invalid.

As for petitioners' resort to the doctrine of Congressional re-enactment of the statute, to establish the validity of the regulation, this doctrine, of course, so far as relevant, applies only to the general validity of the regulation, as it relates to situations clearly and unambiguously covered. It does not in any way establish the validity of the regulation, if given the interpretation now contended for by the Commissioner—a new departure, in contravention of the statute, and certainly neither uniform nor well settled. *U. S. v. Calamaro,* 354 U.S. 351; *U. S. v. Raynor,* 302 U.S. 540, 552; *White v. Winchester,* 315 U.S. 32, 40; *U. S. v. Mo. Pac. R. Co.,* 278 U.S. 269, 280; *Burnet v. Chicago Portrait Co.,* 285 U.S. 1, 16. See *supra,* pp. 55-56.

Respondents strongly urge, however, that it is not necessary for this court to invalidate the Regulation. If possible, as is well established, a regulation should be given a construction which will not violate the statute. *Cf. Com. v. Landers Corp.,* 210 F.2d 188, 191, where the court, construing another portion of Reg. 111, emphasized that "We

cannot give to the Regulations a construction which will violate the language of the statute'' (citing cases). As the court declared, in *Fidelity-Philadelphia Trust Co. v. U. S.*, 122 F.Supp. 551, 553:

> ''The regulation implements the statute and cannot violate or change the statute. *If possible it must be interpreted consistently with Congressional mandate,* but, if in derogation of the statute, it must be declared void as beyond the power of the Commissioner to so regulate. *There is possible a simple, logical interpretation of Reg. 105, Par. 81, 33 that does no violence to the statute.''* (Ital. suppl.)

Similarly, ''in interpreting a regulation courts will ordinarily avoid a construction which *raises doubt* as to its validity.'' *Merten's Federal Income Taxation,* (1942 Ed.) Vol. 1, p. 90; ital. supp.; *Newman et al. v. Com.,* 76 F. 2d 449.

In the present case, likewise, there is a simple, logical interpretation that does no violence to the statute, raises no grave doubts of validity, and carries out the spirit and intent of sec. 44. It is the interpretation of the Regulation in accordance with the usual and proper meaning of its terms and with the practical administrative necessities and justification that led to its adoption. Respondents submit that this is the construction of the Regulation which should here prevail.

## POINT III.

### THE CASE OF CRANE v. COMMISSIONER, 331 U.S. 1, RELIED UPON BY PETITIONER, IS IRRELEVANT TO THE ISSUES OF THIS CASE.

Petitioner's brief relies very heavily upon the case of *Crane v. Com.,* 331 U.S. 1. That case, however, has nothing whatsoever to do with a situation arising under sec. 44. It decided that a taxpayer, who took real property encumbered by a mortgage, by inheritance, and who had taken depreciation in her tax returns on the full value of the property, undiminished by the mortgage, must include the amount of the mortgage in the "amount realized" from a sale of the property, although she never was personally liable thereon. The precise ground of the court's decision was that, under I.R.C. Sec. 113, the basis was the value of the whole physical "property," not merely the value of the equity; and that, to be consistent, the amount realized from the "property," under Sec. 111(b), must likewise use that term in the same sense. The court was deeply influenced by the fact that the taxpayer had claimed, and been allowed, depreciation on the whole value of the property. It further declared (pp. 13, 14), that, as a matter of economic reality, "The owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers them subject to a mortgage, the benefit to him is as real and substantial as if the mortgage were discharged . . ."

It is quite clear, however, that the entire doctrine of the *Crane* case is merely a general one, relating primarily to the determination of "amount realized" on a sale

governed by general principles, and that it has no application whatsoever *to a special statutory situation, where the return of income is governed by special statutory rules, such as Sec. 44.*

The *Crane* case, as stated, arose and was decided in connection with a sale governed by I.R.C. Secs. 111-113—the general provisions covering situations not expressly dealt with otherwise by special enactment. It did not establish any *universal* rule, for the ascertainment of amounts received, in conflict with more specific provisions. Thus, in *Lansdale Structural Steel & Machinery Co.,* 14 T.C. 1428, the court held that the *Crane* case was inapplicable to the question of what constitutes "paid in" invested capital, under the special provisions of I.R.C. Sec. 718.[11]

Specifically, with reference to sec. 44, it has been squarely decided by the Supreme Court that the determination of "amounts received" by the taxpayer reporting under that section, is *not* governed by the rules obtaining for cases arising under Secs. 111-113—the sections of the Code involved in the *Crane* case—but by the *different* rules pertaining to Sec. 44. Thus, in *Com. v. South*

[11]Petitioner's brief (p. 45) cites *Com. v. Fortee Properties*, 211 F.2d 915, as supporting a general application of the *Crane* case. But the Court there merely held that in the particular situation there before it, such doctrine was applicable. The case did not in any way involve the special scheme of Sec. 44, or anything analogous thereto. The Tax Court has refused to follow the *Fortee* case. Moreover, in the *Fortee* case, the vendor was under no personal liability, the property was condemned, and the mortgage paid off, so that the vendor could, by no possibility, remain under any burden. Even so, the Tax Court has refused to follow the *Fortee* case; *Frank W. Babcock,* 28 T.C. 781.

*Texas Co.,* 333 U.S. 496, the Supreme Court declared in so many words, that

> "where a taxpayer has validly reported its income from installment sales on the installment basis provided by sec. 44, *that section, not secs. 111, 112 and 113 prescribes the extent to which receipts from such sales are 'recognized' as taxable and the year in which such receipts* are 'recognized' in computing taxable income." (Ital. suppl.)

This ruling is in entire accord with—in fact, necessary to—the whole special statutory scheme laid down in Sec. 44 for the recognition and return of income in cases arising thereunder; and in accord with its whole general intent, which was, to repeat, to spread the tax evenly over the entire period of "installment payments actually received."

Similarly, in *Rhett W. Woody,* 19 T.C. 350, 354, the court held that the general rules relative to the determination of the amount and nature of gain, where there are no express provisions of the Code, "are not determinative" on issues arising under sec. 44.

Indeed, as the Supreme Court pointed out in the *South Texas* case, *supra,* the statute with reference to which the *Crane* case was decided, Sec. 111, itself specifically guards against any interference with the special statutory scheme of Sec. 44 by reason of the provisions of sec. 111, or any construction of sec. 111 (such as the *Crane* doctrine), by providing as follows:

> "Sec. 111 . . . (d) Installment sales.
>
> Nothing in this section shall be construed to prevent (in the case of property sold under contract provid-

> ing for payment in installments) the taxation of that portion of any installment payment representing gain or profit *in the year in which such payment is received.*" (Ital. supplied.)

Nothing could be plainer than this express statutory recognition of the special statutory scheme for reporting income from installment sales, and this express statutory prohibition of any interference with that special scheme, by reason of the general rules developed in connection with Sec. 111.

Even if it were not expressly so provided, the same conclusions would necessarily follow from the very nature of the special provisions of sec. 44, which are obviously irreconcilable with the general method of reporting income.

Economic gain, under sec. 44, is recognized only to the extent that it is compatible with the provisions of that section. The mere fact that, according to the ordinary rules, a vendor realizes certain income in the year of sale, affords no excuse for violation of the statute. Sec. 44 was enacted for the very purpose of enabling the taxpayer to follow a *different* system of reporting, and to defer the taxation of income otherwise indubitably taxable in the year of sale; and its provisions must be followed, and the taxation of profit deferred, if the sale is reported under sec. 44, no matter what actual economic benefit, and what security, the seller receives in the year of sale. Thus, evidences of indebtedness of the purchaser may not be taxed, even if represented by negotiable notes, and even if those notes are secured, and have a fair market value of 100% of their face. Indeed, the purchaser's obligations

may not be included in "initial payments" even if they are amply secured by *independent* collateral, unconnected with the subject of the sale. *R. L. Brown Coal & Coke Co., et al.,* 14 B.T.A. 609, 614; *Mertens, Fed. Inc. Tax,* (1942 Ed.) Vol. 2, p. 478. This is far more security than the respondents herein could possibly be said to enjoy, merely because of the practical considerations adverted to in the *Crane* case; but the terms and special scheme of the statute are unaffected thereby, and must none the less be followed.

Moreover, it should be noted that the *Crane* doctrine is one based upon economic realities, rather than technical rules, and that, even aside from Sec. 44, it would be here utterly inappropriate. In the *Crane* case itself, the seller was said to have realized income to the amount of the mortgage, in the year of sale, even though the purchaser did not assume the mortgage, because, as a practical matter, the seller was at that time entirely relieved from the burden. But in the *Crane* case, the seller was not, herself, personally liable, so that, upon the sale, she had no further possible involvement or responsibility on the mortgage. Similarly, in other cases following the *Crane* case, the sale was under such circumstances that the seller was completely absolved of all liability, or else, the property itself was ample security beyond any reasonable contingency, for the debt. In no case has the *Crane* doctrine been applied *where the seller remained personally liable,* and the property was not clear and ample security for the obligation. In the instant case, however, as shown above (*supra,* p. 12) not only did respondents remain personally and solely liable, but there was a 90%

mortgage on the property; the purchasers had only the most dubious responsibility, and the expenses attendant upon default would completely consume the equity; any slight change in realty values would immediately produce a deficiency; and against the background of the highly uncertain war conditions then prevailing, the burden of vendor's continuing liability could not, as a matter of "economic reality," on which the *Crane* doctrine is based, in any reasonable sense be said to have been lifted. *Cf. Clinton Park Development Co.,* 209 F. 2d 951. Under these circumstances and even if the special and entirely incompatible scheme of Sec. 44 were not here involved and controlling, it would be a parody upon the spirit and reasoning of the *Crane* case, to attempt to apply it to the facts of the present case.

Indeed, the very Regulation here in question itself furnishes conclusive proof of the entire inapplicability of the *Crane* doctrine to sec. 44. For the Regulation, first promulgated in 1926, shortly after the enactment of the statute, so far from attempting to reach the amount of the mortgage, as presently received income in the year of sale, *excluded* the entire amount of the mortgages dealt with, from "initial payment." This is not the *Crane* doctrine; it is the exact opposite.

Nor did the amendment of the Regulation in 1929, introducing the present provision respecting the inclusion of "excess" of mortgage over vendor's basis, as part of "initial payment" (in the case of assumed mortgages, or where the property is taken "subject to" the mortgage, in the usual sense explained in Point I), make any change in this respect. The *Crane* case has nothing to do with mere

"excess;" its rationale, where applicable at all, requires the recognition of the *entire amount* of the mortgage as part of the "amount received" at the time of the sale—not merely a part of it. The Regulation regarding "excess" did not adopt any such theory; it totally rejected it; and was promulgated as shown in detail in Point I, merely as a matter of practical administrative necessity, to plug a loophole in the scheme, and prevent the escape of income from taxation.

Petitioner's invocation of the *Crane* case as authority for the procedure followed by him indicates, it is submitted, a fundamental misconception of the question, here to be decided. It is not a question, here, of what Congress intends shall be recognized as received income, in the ordinary case. It is solely a question of what Congress intended to recognize as income in the *special* case of installment sales reported under sec. 44. With this issue, the *Crane* case does not concern itself, and plays no part. And if the regulation here involved were to be construed, as contended for by petitioner, on the strength of the views expressed in that case, it would still be invalid, because of direct conflict with the specific provisions of sec. 44, discussed in Point II, *supra.*

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## CONCLUSION.

This court has not looked with favor upon regulations, or strained constructions of regulations, which tamper unnecessarily with the plain provisions of sec. 44 and curtail the privilege there granted. *Gilbert v. Com.,* 241 F. 2d 491. In the present case, likewise, the plain provisions of sec. 44 are applicable without any complications

arising, any profit escaping, or any collection of taxes being unduly deferred. As Petitioner's brief (p. 20) itself concedes, the profit, under the interpretation contended for by respondents and adopted by the Tax Court below, is spread *"over the life of the sales contract."* It is submitted that this is precisely what sec. 44 intends, and demands.

Dated, San Francisco, California,
January 20, 1958.

Bert F. Rabinowitz,
*Attorney for Respondents.*

**(Appendices A and B Follow.)**

# Appendices.

## Appendix A

| Petitioner's Exhibits | Stipulated |
|---|---|
| The Stonecrest Corporation | |
| 1-A | R. 22 |
| 1-B | R. 22 |
| 3(b) | R. 23 |
| 3(c) | R. 23 |
| 3(d) | R. 23 |
| 3(e) | R. 23 |
| 3(f) | R. 23 |
| 4(a) | R. 23 |
| 5(a) | R. 23 |
| 5(b) | R. 23 |
| 5(c) | R. 24 |
| 6(a) | R. 24 |
| 6(b) | R. 24 |
| 6(c) | R. 24 |
| 6(d) | R. 24 |
| 7(a) | R. 25 |
| 7(b) | R. 25 |
| 7(c) | R. 25 |
| 7(d) | R. 25 |
| 7(e) | R. 25 |
| 7(a-1) | R. 25 |
| 7(a-2) | R. 25 |
| 7(a-3) | R. 25 |
| 8(a) | R. 27 |
| 8(b) | R. 27 |
| 8(c) | R. 27 |
| 9(a) | R. 37 |
| 9(b) | R. 37 |
| 9(c) | R. 38 |
| 9(d) | R. 38 |
| The Brookfield Corporation | |
| 1-A | R. 51 |
| 1-B | R. 52 |

The exhibits attached to the stipulation filed by the Stonecrest Corporation (R. 19-48) and designated as Exhibits 3(b), 3(c),

3(d), 3(e), 3(f), 4(a), 5(a), 5(b), 5(c), 6(a), 6(b), 6(d), 7(a), 7(a-1), 7(a-2), 7(a-3), 7(b), 7(c), 7(d), 7(e), 8(a), 8(b), 8(c) and 9(a), 9(b), 9(c), 9(d) are identical to the corresponding form or agreements used by Brookfield Corporation with the exception that the name Brookfield was substituted for the name Stonecrest on the documents with respect to agreements or business forms used by Brookfield (R. 54).

## Appendix B

The figures set forth in the schedule of amounts *involved* in this appeal (Pet. Br. p. 2) are merely the amounts specified in the Commissioner's Notices of Deficiency, both dated April 9, 1952 (R. 7, 69, 120-121), with the following exceptions and modifications.

1. They do not reflect the over-assessment of Income Tax for the year 1943 in the amount of $4,422.24, determined by the Commissioner in his said Notices of Deficiency addressed to Respondent Stonecrest (such over-assessment automatically following from the decrease in income subject to Income Tax, occasioned by the petitioner's increase of income subject to Excess Profits Tax.)

2. They add and include over-assessments and exclude deficiencies found by the Tax Court in its decisions herein, dated October 13, 1955 (Pet. Br. p. 2; R. 140, 141-142).

In addition, it is to be noted that petitioner's schedules of the amount involved in the appeal have not been adjusted by him to reflect the effect of the following Stipulations entered into by the parties, viz:

(a) Allowable officers' salaries for the years 1944 and 1945 as to each respondent (R. 90).

(b) Recognition that in the case of Respondent Brookfield, 49 contracts were reported as Deferred Payment Sales (not on the Installment Method) and that their fair market value at the respective dates of sale was 66⅔% of their face value (R. 50-51, 60-61, 117-119).

(c) Agreement that if the petitioner herein prevails, net operating loss carry-backs and resulting unused excess profits credit carry-backs resulting from the determination of Respondent Brookfield's income for the years 1946 and 1947 in accordance with such a decision, would be duly taken into consideration in determining the deficiencies in Income and Excess Profits Taxes due from such respondent for the years 1942, 1943, 1944 and 1945 (R. 57-59).